Future of the Functional Test (At this Junction, Will It Function?)

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Contents

I. Introduction[1]

This paper contains a discussion of the current state of the functional test of business income. It begins with a historical background, which includes a discussion of UDITPA's business income provisions, pertinent state statutes and regulations, and some applicable federal concepts. It continues with an examination of a number of recent and pending business income characterization cases. The paper concludes by laying out a number of functional test hot issues including extraordinary events, what property is subject to the test, the meaning of "integral," and whether "acquisition, management, and disposition" should be read in the disjunctive or the conjunctive.

Scholars and practitioners are by no means agreed on exactly what the current state of the functional test of business income is, nor are they agreed on how the "hot issues" should be interpreted. Because the panelists presenting this paper are no different, this should be kept in mind when reading the views expressed here. Individual authors have contributed to this paper and, in the interests of stimulating a free exchange of viewpoints, have been given the freedom to approach each individual topic as they saw fit. Thus, the views expressed by each author on each individual topic should not necessarily be read as representing the views of the panel as a whole or of all of its members. Accordingly, individual authorship of each section comprising this paper is indicated by footnote.

II. Historical Background

A. UDITPA and State Law[2]

Are we at a crossroads requiring us to consider whether various states' statutes needs must be amended to clearly and separately provide for the "functional test"? The only courts deciding whether a functional test existed (exclusive of the California cases and *District of Columbia* v. *Pierce Associates*, 462 A.2d 1129 (D.C. App. 1983), and until *Kroger Co* v. *Department of Revenue*, 284 Ill. App. 3d 473, 220 Ill. Dec. 566 [673 N.E.2d 710] (Ill. App. 1st Dist. 1996), pet. for leave to appeal denied, 171 Ill. 2d 567 [677 N.E.2d 966] (1997) and *Texaco-Cities Pipeline* v. *McGaw*, 182 Ill. 2d 262 [695 N.E.2d 481] (1998); see discussion below), determined based upon "statutory interpretation" that the functional test was not a separate alternate test. Until the late 1990s, only a few courts actually considered whether a separate alternative functional test existed, namely, those in *General Care Corporation* v. *Olsen*, 705 S.W.2d 642 (Tenn. 1986), *Western Natural Gas Co.* v. *McDonald*, 202 Kan. 98 [446 P.2d 781] (1968); *McVean & Barlow, Inc.* v. *New Mexico Bureau of Revenue*, 88 N.M. 521 [543 P.2d 489] (1975), cert. denied, 89 N.M. 6 [546 P.2d 71] (1975); *In re: Chief Industries, Inc.*, 255 Kan. 640 [875 P.2d 278] (1994).[3] After the negative decisions in Tennessee, Kansas, and New Mexico, each of the these three states

[1] Authored by Fred Campbell-Craven.

[2] Authored by Deborah Mayer.

[3] For the more recent cases, see attached chart of states; for example, Minnesota's recent decisions in *Firstar Corporation* v. *Commissioner of Revenue*, 575 N.W.2d 835 (Minn. 1998) and *Hercules* v. *Commissioner of Revenue*, 575 N.W.2d 111 (Minn. 1998). See also HELLERSTEIN & HELLERSTEIN, STATE TAXATION 3D ED., Chapter 9, ¶ 9.05[2], fn. 102 (Warren, Gorham & Lamont/RIA Group 1997).

amended their law incorporating the functional test, either by substituting "or" for "and" ("acquisition, management *or* disposition")[4], or as in the case of Kansas, by providing taxpayers with an election to apply the functional test. In *Phillips Petroleum Co.* v. *Iowa Dep't of Revenue and Finance*, 511 N.W.2d 608 (Iowa 1993), the Iowa Supreme Court noted that other jurisdictions only pay lip service to the functional test while uniformly rejecting it as a vehicle to allow taxation under similar circumstances, and concluded that Iowa's statute contained only one test.

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[4] Tennessee:

> "Business earnings" mean earnings arising from transactions and activity in the regular course of the taxpayer's trade or business or earnings from tangible and intangible property if the acquisition, use, management *or* disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. In essence, earnings which arise from the conduct of the trade or trades or business operations of a taxpayer are "business earnings," and the taxpayer must show by clear and cogent evidence that particular earnings are classifiable as nonbusiness earnings. A taxpayer may have more than one (1) regular trade or business in determining whether income is "business earnings." This subdivision expresses the legislative intent to implement and clarify the distinctions between business and nonbusiness earnings, as found in the Uniform Division of Income for Tax Purposes Act, as generally interpreted by states adopting the act.

Tenn. Code Ann. § 67-4-2004 (1999). (Emphasis added.)

Kansas: Provides an election: "for taxable years commencing after December 31, 1995, a taxpayer may elect that all income derived from the acquisition, management, *use or* disposition of tangible or intangible property constitutes business income. The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations."

K.S.A. § 79-3271(a). (Emphasis added.)

New Mexico: "Business income includes income from tangible and intangible property if the acquisition, management *or* disposition of the property constitute integral parts of taxpayer's regular trade or business operations."

N. Mex. Stat. Ann. 1978 § 7-4-2(A) (June 18, 1999). (Emphasis added.)

It should also be noted that the statutes of some states, North Carolina for example, provide for both the conjunctive and disjunctive:

> [Business income includes] income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, *and/or* disposition of the property constitute integral parts of the corporation's regular trade or business operations.

N.C.G.S. § 105-130.4(a)(1) (1985). (Emphasis added.)

Idaho's business income definition is in the disjunctive:

> 'Business income' means income arising from transactions and activity in the regular course of the taxpayers' trade or business and includes income from the acquisition, management, **or** disposition of tangible and intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayers' trade or business operations.

Idaho Code §§ 63-3027 and 3701. (Emphasis added.)

Iowa was prompted to modify its statute after the decision.[5] Most recently, Alabama's Supreme Court determined that if a separate alternative functional test existed, it would "swallow" the functional test. (See discussion of *Uniroyal Tire Co.* v. *State Dep't of Revenue*, Docket No. 1981928, Supreme Court of Alabama (Aug. 4, 2000), *infra*.)

Early California Cases Develop Functional Test And Transactional Tests Based On Unitary Business Analysis

The "functional" test has been around since the 1940s and early 50s, starting with various California State Board of Equalization cases such as *Appeal of Marcus Lesoine, Inc.*, *Appeal of Houghton-Mifflin*, *Appeal of International Business Machine*, *Appeal of American Snuff Corporations*, and the California Supreme Court's decision in *Holly Sugar Co.* v. *Johnson*, 18 Cal. 2d 218 [115 P.2d 8] (1941) cited in the *Lesoine* and *Houghton-Mifflin* decisions. Those cases all had several common threads. First, the income was from intangibles; second, the entities conducted a unitary business. These cases actually established the "functional test" for business income now adopted and applied by 28 out of 45 states (including the District of Columbia).[6] (See attached chart for a brief description of each state's case and statutory law on the subject.) The other common thread was the existence of a unitary business structure.

In *Marcus Lesoine*, the California State Board of Equalization observed that interest collected on conditional sales contracts constituted an "integral" asset of the taxpayer's business: "[T]he acquisition, management and *liquidation* of the intangibles constitute integral parts of the corpora-

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[5] Iowa Code Ann. § 422.32 provides:

> Business income means income arising from transactions and activity in the regular course of the taxpayer's trade or business; or income from tangible and intangible property if the acquisition management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations; or gain or loss resulting from the sale, exchange, or other disposition of real property or of tangible or intangible personal property if, if the property while owned by the taxpayer was operationally related to the taxpayer's trade or business carried on in Iowa or operationally related to sources within Iowa, or the property was operationally related to sources outside this state and to the taxpayer's trade or business carried on in Iowa; or gain or loss resulting from the sale exchange or other disposition of stock in another corporation if the activities of the other corporation were operationally related to the taxpayer's trade or business carried on in Iowa while the stock was owned by the taxpayer. A taxpayer may have more than one regular trade or business in determining whether income is business income. It is the intent of the general assembly to treat as apportionable business income all income that may be treated as apportionable business income under the Constitution of the United States. (January 1, 1995)

[6] Those states that apply the functional test (in addition to the transactional test) either by case law or statute: Alaska, Arizona, Arkansas, California, Colorado, (District of Columbia), Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Mississippi, Missouri, Montana, Nebraska, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Tennessee, Utah, and Wisconsin.

The following states are "full apportionment within constitutional limitation states": Connecticut, Delaware, Maryland, Massachusetts, Michigan, Minnesota, New Hampshire, Rhode Island, South Carolina, Vermont, Virginia and West Virginia.

"Not susceptible of a particular classification" are: Florida and New York.

tion's business operations." (Emphasis added.)

In *Houghton-Mifflin*, the SBE observed that the intangibles were integral parts of the taxpayer's unitary business; indeed, but for the taxpayer's book publishing business, the "intangibles ["second serial sales," copyrights generating royalties on foreign sales, "plate rentals," and sales of books to Warner Brothers, Inc.] would have little or no value". The SBE observed: "the acquisition management and disposition of the intangibles constitute integral parts of the corporation's regular business operations."

In *Holly Sugar Co.*, a foreign corporation acquired the majority shares in a California company to enhance its ongoing business. The court determined that the companies were integrated, and that each company contributed to the benefit of Holly Sugar as a whole. Consequently, when the stock was sold at a loss, the foreign corporation had to include it in its income subject to the "allocation formula."

Finally, IBM researched and developed patents used in various types of office equipment. Not only did it derive income from the sale and rental of the equipment, but it also received royalties for the use of patents in foreign countries. In allowing the royalties to be taxed by California under what we now consider to be the functional test, the SBE observed: "we have previously held that income from such intangibles is subject to allocation where the acquisition, management and disposition of the intangibles constitute integral parts of the owner's regular business operations." The SBE reasoned that these intangibles were nothing more than the "business machines and equipment upon which the patents were developed for use in Appellant's regular business operations." The expenses incurred in connection with these patents, such as research and development, salaries of employees, and the cost of securing and protecting the patents, were all normal expenses of "its regular business operations. Under such circumstances, the exploitation of its patents by licensing their use in foreign countries also constitutes, in our opinion, an integral part of Appellant's regular business activities."

In *American Snuff*, the corporation sold its product to independent distributors throughout the US who, in turn, sold it to retailers. It had full-time California employees who called on retailers to promote the sale of its merchandise. American Snuff had no office or other place of business in California. (There was an 86-272 issue, not pertinent for the discussion here). California included as part of the taxable income interest from notes receivable and mortgages receivable from its employees, as well as earned discounts in both the group insurance premiums and retirement income plans. In holding that the interest could be taxed under what we today consider a functional test analysis, the SBE cited its three prior decisions in *Lesoine*, *Houghton-Mifflin*, and *IBM*:

> In those decisions we stated that income from intangibles is part of the unitary income subject to allocation where the acquisition, management and disposition of the intangibles constitute integral parts of the owner's regular business operations. In each of those cases, the income was directly related to the activities of the unitary business. Here the loans which gave rise to the interest were made for the purpose of increasing the efficiency of the employees and they, accordingly, contributed to the operations of the unitary business. We are, therefore, of the opin-

ion that the interest is includible in unitary income.

As to the interest income received in the form of discounts on insurance and annuity premiums:

> [T]he premiums were deducted by Appellant from the unitary income. We believe that the discount should be included . . . since it would have been equally correct from an accounting viewpoint to regard the discount as a reduction of the premium expense rather than as a separate item of income.

Enactment of UDITPA Included Both Tests Based Upon California Precursor Law, Comments, and Reinforced by Regulatory Presumption

UDITPA, the "Uniform Division for Income Tax Purposes Act," arrived on the scene in 1957. The "prefatory note" states:

> The Uniform Division of Income for Tax Purposes Act is designed for enactment in those states that levy taxes on or measured by net income.
>
> The need for a uniform method of division of income for tax purposes among the several taxing jurisdictions has been recognized for many years and has long been recommended by the Council of State Governments. There is no other practical means of assuring that a taxpayer is not taxed on more than its net income. At present there are various formulae for determining the amount of income to be taxed in use by the states, and the differences in the formulae produce inequitable results. Many states now use the three factor formulae of this Act. The problem has been well analyzed and its historical background outlined in an article appearing in 18 *Ohio State Law Journal*, page 84.
>
> The Uniform Division of Income for Tax Purposes Act is the result of conferences with the representatives of the Controller's Institute of America, the Council of State Governments and various interested individuals. It was promulgated in 1957.[7] The comments in the present reprinting of the Act were revised and extended in February 1966 in order to clarify the solutions to some of the problems which have been experienced in securing enactment of the Act in the several

[7] Twenty-two jurisdictions plus the District of Columbia have adopted UDITPA. (See attached chart): Alabama, Alaska, Arizona, Arkansas, California, Colorado, (District of Columbia), Hawaii, Idaho, Kansas, Kentucky, Maine, Michigan, Missouri, Montana, Nebraska, New Mexico, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. See, Chart of Jurisdictions Adopting UDITPA, attached as an exhibit to this paper. UDITPA was adopted as Article IV of the "Multistate Tax Compact." The first eight states entered into the Compact on August 4, 1967. Currently, there are 21 Members of the Multistate Tax Compact: Alabama, Alaska, Arizona, Arkansas, California, Colorado, D.C., Hawaii, Idaho, Kansas, Maine, Michigan, Minnesota, Missouri, Montana, North Dakota, Oregon, South Dakota, Texas, Utah and Washington. *Model Regulations, Statutes and Guidelines*, Multistate Tax Commission (April, 1998). The Compact was promulgated to promote "uniformity or compatibility in significant components of tax systems," to facilitate the "proper determination of State and local tax liability of multistate taxpayers, including the equitable apportionment of tax bases and settlement of apportionment disputes," to facilitate "taxpayer convenience and compliance in the filing of tax returns and other phases of tax administration," and to avoid "duplicative taxation." *Id.*

states.

[Be It Enacted . . .]

SECTION 1. As used in this Act, unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Comment

This definition refers to "the" taxpayer's trade or business as if he had one business. It is not intended by this language to require a taxpayer having several "businesses" to use the same allocation and apportionment methods for the businesses. The language permits separate treatment of different businesses of a single taxpayer. Section 18 clearly permits separate treatment. *Income from the disposition of property used in a trade or business of the taxpayer is includible within the meaning of business income.* (Emphasis added.)

….

(e) "Non-business income" means all income other than business income.[8]

The Multistate Tax Compact established as its administrative agency the Multistate Tax Commission ("MTC"). In the mid-70's, the MTC promulgated regulations interpreting UDITPA and established a presumption that all income was business income unless clearly classifiable as nonbusiness income. MTC Reg. IV.1.(a).

Supreme Court Decisions Recognize Both Tests and Continue Unitary Business Analysis

These tests (functional and transactional) set forth in the definition, just like the precursor cases,

[8] The original draft of UDITPA drew no distinction between business and nonbusiness income. It was only amended to reflect such a distinction when California suggested the value of such a distinction. The UDITPA definition of business income was based on the proposed definition submitted by John Warren of California to the California State Board of Equalization in February, 1965. In that letter, Mr. Warren stated:

> [W]e felt the treatment of royalties was in conflict with the decisions of the State Board of Equalization . . . which had upheld formula apportionment of such income where the acquisition, management and disposition of the patents or copyrights constituted integral parts of the taxpayer's regular trade or business.

James H. Peters, *The Distinction Between Business Income and Nonbusiness Income*, 25 S. CAL. TAX INST. 251, 272 (1973).

link the determination of whether an item is business income to the existence of a unitary business, almost blurring the distinction between the two analyses. In fact, that is the history of the Supreme Court litigation until we get to *Allied Signal*, 504 U.S. 768 (1992). That is exactly what happened when the Supreme Court analyzed these provisions in *ASARCO, Inc.* v. *Idaho*, 458 U.S. 307 (1982) and in *F.W. Woolworth Co.* v. *Taxation & Revenue Dep't*, 458 U.S. 354 (1982). In *ASARCO* the Supreme Court concluded that since ASARCO was not in a unitary business with the corporations that paid dividends or the corporations that paid the interest and capital gain income, the income was not business income apportionable to Idaho. As to the dividend income, the Court quoted its opinion in *Mobil:* "Where the business activities of the dividend payor have nothing to do with the activities of the recipient in the taxing state" (445 U.S. at 442) the dividends cannot be apportioned to the taxing state. As to the interest and capital gain income the court also quoted *Mobil* and said "one must look principally at the underlying activity, not at the form of investment to determine the propriety of apportionability." 445 U.S. at 440. The *ASARCO* Court balked at the suggestion that the definition of a unitary business be expanded to include such income, stating that its inclusion would destroy the concept of unitary businesses. 458 U.S. at 326.

F. W. Woolworth Co. v. *Taxation & Revenue Dep't*, 458 U.S. 354 (1982), decided on the same day, had the same results. New Mexico could not tax the dividends, foreign currency transactions, and gross-up income from Woolworth's foreign majority-owned subsidiaries because Woolworth was not "unitary" with its subsidiaries. In a scathing dissent in both cases, citing *Wisconsin* v. *J.C. Penney Co*., 311 U.S. 435, 445 (1940), Justices O'Connor, Blackmun and Rehnquist (an unlikely combination) accused the majority of "injecting itself in a merely negative way into the delicate processes of fiscal policy-making," and "regrettably 'imprison[ing] the taxing power of the states within formulas that are not compelled by the Constitution."

State Court Decisions Employ Unitary Business Analysis and Recognize Both Tests

State court cases recognizing the "functional" test engaged in the same type of unitary analyses prior to 1992 as well. In *District of Columbia* v. *Pierce Associates*, 462 A.2d 1129 (D.C. App. 1983), the taxpayer, a mechanical contractor in the business of furnishing and installing plumbing heating and air conditioning systems as well as running a manufacturing plant that produced sheet metal ducts, automatic sprinklers, and specialties used in the contracting business, suffered a flood in its manufacturing plant. It recovered under its insurance policy and the District of Columbia apportioned the proceeds as business income. The D.C. Court of Appeals concluded that:

> [T]he District reasonably may decide that "the acquisition, management, and disposition of . . . property constitute[s] an integral part[ ] of the taxpayer's regular trade or business," D.C. Code §47-441 Art. IV(1)(a), if—however sporadically—it arises out of normal business operations. If the property had an integral function in the taxpayer's unitary business, its income properly can be apportioned and taxed as business income, even though the transaction itself does not reflect the taxpayer's normal trade or business. See *Qualls v. Montgomery Ward & Co.*, 266 Ark. 207, 221-22, 585 S.W.2d 18, 26 (1979) (under UDITPA, taxable business transactions "are not required to be in the course of [the taxpayer's] regular trade. It is only required that the transactions be in the 'regular course of

> It is only required that the transactions be in the 'regular course of the taxpayer's trade or business operations.'" (citations omitted)); *Times Mirror Co., supra*, 102 Cal.App.3d at 877, 162 Cal. Rptr. at 633 (under UDITPA, inquiry is whether income arises in main course of taxpayer's business); *W.R. Grace & Co. v. Commissioner of Revenue*, 378 Mass. 577, 583, 393 N.E.2d 330, 334 (1979) (construing similar legislative language, gain from taxpayer's sale of stock interests in other company can be taxed as business income because stock holdings were "integral component in [the taxpayer's] total operation"); *Montana Department of Revenue v. American Smelting & Refining Co.*, 173 Mont. 316, 326, 567 P.2d 901, 907 (1977), appeal dismissed, 434 U.S. 1042, 98 S. Ct. 884, 54 L.Ed.2d 793 (1978) (under regulations exactly paralleling UDITPA's definition of business income, patent royalties and mine royalties were business income because they "derived from sources that are integral portions of [the taxpayer's] business"); *Johns-Manville Products Corp. v. Commissioner of Revenue Administration*, 115 N.H. 428, 430-31, 343 A.2d 221, 222-23 (1975) (per curiam), appeal dismissed, 423 U.S. 1069, 96 S. Ct. 851, 47 L.Ed.2d 79 (1976) (sale of timberland taxable as business income where land was "held as a means of furthering the unitary business, was carried on the books as an asset, was purchased with income produced by the unitary business, the same officers controlled the business and the investment, and where the income and any gain was comingled [sic] with other income and used in the business"). (Footnotes omitted.)

The Court of Appeals reasoned that the manufacturing plant had been an "integral" part of the taxpayer's business because it furthered the business of furnishing and installing mechanical systems and because the taxpayer had previously deducted from its DC taxes all expenses incurred in connection with running the manufacturing plant, including depreciation and deductions for "wear and tear." This analysis closely tracks the definition of a unitary business group.

In *National Realty and Investment Company* v. *Illinois Department Of Revenue*, 144 Ill. App.3d 541 [494 N.E. 2d 924] (2nd Dist. 1986), the Illinois Appellate Court engaged in an interesting analysis of the taxpayer's business (not exactly a unitary analysis, but close) after recognizing both the transactional and functional tests were included in Illinois' definition of business income (which is identical to UDITPA's).

In recognizing both tests, the Appellate Court agreed with the Department of Revenue's reliance on *District of Columbia* v. *Pierce* (for the definition of the transactional test), and *Atlantic Richfield Co*. v. *State of Colorado*, 198 Colo. 413 [601 P.2d 628, 631] (1979) (for the definition of the "alternative" functional test). The Appellate Court held that under the functional test, the gain on disposition of property is properly characterized as business income "if the property disposed of was used by the Taxpayer in its regular trade or business operations." 144 Ill. App. 3d 554. The taxpayer and the Department agreed both tests applied to the case. *Id.*

The taxpayer had purchased a piece of property with the intention of developing condominiums. Without ever developing it, National Realty sold the property at a substantial gain. The question was how to characterize the gain. The court attempted to analyze the taxpayer's business but noted there was insufficient evidence in the record to determine the exact nature of its business.

The taxpayer only introduced its articles of incorporation (broad and vague), state and federal income tax returns (reflecting income from profits, capital gains, rents and from dividends and interest), and corporate balance sheets (listing assets including cash, certificates, accounts and notes receivable inventories of saleable merchandise, stock investments, a hotel, and other property and equipment including land and improvements). Nothing in the stipulation of fact described the actual nature of the taxpayer's business. The court noted that nothing in the record supported the ALJ's finding that the taxpayer was in the business of managing improved properties and the development of condominiums, but the facts in the record were broad enough to permit the court to conclude that the taxpayer's business was "apparently varied and diversified," and that the taxpayer failed to meet its "burden to show the gain from the sale of the Vero Beach property is nonbusiness income." 144 Ill. App. at 554.

Two Tests Remain But Move from "Unitary Analysis" To Operational-Function Analysis

Finally, *Allied-Signal* gave us a new way of looking at whether a non-unitary asset's disposition could be considered "business income." Many discourses have been written on the Supreme Court's analysis, which failed to establish a "bright-line" test for determining an "operational function." Absent a unitary relationship between the stockholder and the corporation, the Court in *Allied-Signal, Inc.* v. *Director, Division of Taxation*, 504 U.S. 768 (1992), required that the stockholder's ownership of the stock serve an operational rather than investment function in order for the resulting income to be apportionable. 119 L.Ed.2d 533 at 550, 552. The Court gave one illustration:

> [A] State may include within the apportionable income of a non-domiciliary corporation the interest earned on short-term deposits in a bank located in another state if that income forms part of the working capital of the corporation's unitary business.

Id., at 552.

Allied-Signal was the successor in interest to the Bendix Corporation. From December, 1977 through November, 1978, Bendix acquired 20.6 percent of ASARCO's stock by purchases on the open market. In the first half of 1981, Bendix sold this stock, realizing a sizeable gain. Part of the gain was apportioned to New Jersey.

Bendix was organized in four major operating groups: automotive; aerospace/electronics; industrial/energy; and forest products. Bendix's primary operations in New Jersey were the development and manufacture of aerospace products. ASARCO produced nonferrous metals, treating ore taken from its own mines and ore obtained from other sources. The parties stipulated during the trial that Bendix held its investments in ASARCO, they were in unrelated businesses, and that no elements of functional integration, strong centralized management, or economies of scale existed.

The issues addressed to the Court were:

(1) whether the unitary business principle still remained an appropriate vehicle for determining whether a state violated constitutional limitations on its taxing ability; and

(2) whether, under unitary business principles, New Jersey had the power to include in apportionable income certain income not generated in the unitary business.

The answer to (1) was "yes," and the answer to (2) was "it depends" upon whether the income is operational or investment.

Although a unitary relationship between the payor and payee (investor and the investment) was not required by the Court, it still remained a viable method of meeting constitutional Due Process and Commerce Clause limitations on a state's ability to tax a non-domiciliary corporation's income. *Id*. Regarding the Due Process Clause, the Court noted that "there must be a connection to the activity itself, rather than a connection only to the actor the State seeks to tax." *Id*., at 546, citing *Quill Corp*. v. *North Dakota*, 504 U.S. 298 (1992), quoting *Miller Bros. Co.* v. *Maryland*, 347 U.S. 340, at 344-345 (1954). The Court asserted that the Commerce Clause circumscribed a state's right to tax activities occurring outside its borders because of the "drastic consequences for the national economy, as businesses could be subjected to severe multiple taxation." 119 L.Ed.2d 533, at 545-546.

The Court referred to the MTC's Amicus Curiae Brief in which it urged the Court to hold that the Constitution does not require a unitary business relation between the payor and payee in order for a state to apportion the income the payee corporation receives from an investment in the payor as business income. Although the Court agreed that the definitions contained in UDITPA may be compatible with unitary business principles, and that the unitary business principle was not so inflexible that as new methods of finance and new forms of business evolved it could not be modified or supplemented where appropriate, it held that New Jersey had failed to offer anything more than the fact that Bendix was present within its borders.

The operational function test is left undefined. One could presume that it would allow a state to tax in those circumstances allowed under UDITPA. UDITPA includes as apportionable business income, as does New Jersey, any income arising from "tangible and intangible property if the acquisition, management and disposition of the property constitute an integral part of Taxpayer's trade or business operations."

Therefore, it is clear that the payor and payee need not be engaged in the same unitary business as a prerequisite to apportionment. Instead, the capital transaction must serve as an operational rather than investment function. Hence, in *ASARCO*, although the majority rejected the dissent's factual contention that the stock investments constituted "interim uses of idle funds 'accumulated for the future operation of [the taxpayer's] business operation,' [the majority] did not dispute the suggestion that had that been so, the income would have been apportionable."

To exclude income from the apportionment formula, the taxpayer must prove that the income was earned in the course of activities unrelated to those carried on in the taxing state. *Exxon Corp*. v. *Wisconsin Dept. of Revenue*, 447 U.S. 207 (1980). The Court in *Allied Signal* noted that a state may include within the apportionable income of a nondomiciliary corporation the interest

earned on short-term deposits in a bank located in another state if those deposits form part of the working capital of the corporation's unitary business, notwithstanding the absence of a unitary business relationship between the corporation and the bank. The Court noted:

> That is the relevant unitary business inquiry, one which focuses on the objective characteristics of the asset's use and its relation to the taxpayer and its activities within the taxing State. It is an inquiry to which our cases give content, and which is necessary if the limits of the Due Process and Commerce Clauses are to have substance in a modern economy.

119 L.Ed.2d 533 at 550.

In *Kroger Co*. v. *Department of Revenue*, 284 Ill. App.3d 473 [673 N.E.2d 710] (Ill. App. Ct. 1st Dist. 1996), pet. for leave to appeal denied, 171 Ill. 2d 567 [677 N.E.2d 966] (Ill. 1997) the sale of the taxpayer's leasehold interests was held to be business income. Faced with deciding whether two tests existed side-by-side, the court rejected the "last antecedent doctrine" as asserted by the taxpayer and noted that the definition contains a "compound predicate." The words "regular course of business" were not included in the second clause, but instead were replaced by "constitute integral parts of taxpayer's regular trade or business operations." This "second definition refers to the conditions of ownership of property by the taxpayer; it is not limited to a taxpayer's trade or business, such as Kroger's retail business, but includes 'operations' of the taxpayer's business, such as the sale of leasehold interests." *Id*., at 480.

The court noted that since the Illinois Supreme Court's decision in *National Realty* finding that two separate tests existed, the Illinois General Assembly had amended the definitional section of the Illinois Income Tax Act six times in the period since its enactment and did not amend the definition of "business income." *Id*. "A court's construction of a statute is considered part of the statute itself, unless and until the legislature amends it." *Id*.

The court in *Texaco-Cities Service Pipeline Company* v. *McGaw*, 182 Ill. 2d 262 [695 N.E.2d 481] (1998) held that the gain on the "sale of major segments of its pipeline assets and associated real estate including its entire contingent of pipeline assets in Illinois . . .by a company in the business of transporting crude oil by pipeline and in the business of operating pipelines in Illinois," constituted business income under the functional test. It determined that the assets sold were "integral" assets of the taxpayer's regular trade or business.

In so holding. the Illinois Supreme Court noted:

> Initially, we cannot agree that the second clause of section 1501(a)(1) is simply a subset of the first clause. The first clause consists of general language encompassing all activity in the "regular course of the taxpayer's trade or business." *The second clause enlarges this definition to include income from property, as long as its "acquisition, management, and disposition" constitute "integral parts of the taxpayer's regular trade or business operations." The predicate phrase "in the regular course of business" is replaced in the second clause with "integral parts of regular business operations," resulting in two manifestly different definitions.*

> See *Kroger Co. v. Department of Revenue,* 284 Ill.App.3d 473, 479, 220 Ill. Dec. 566, 673 N.E.2d 710 (1996). (Emphasis added.)

182 Ill. 2d 262, 271 [695 N.E.2d 481, 485].

> Turning to the meaning of the second clause, we note that the term "integral" means "of, relating to, or serving to form a whole: to completeness: organically joined or linked." Webster's Third New International Dictionary 1173 (1993). The term "operations" is defined as "b: the whole process of planning for and operating a business or other organized unit * * * c: a phase of a business or of business activity." Webster's Third New International Dictionary 1581 (1993). Placed in their statutory context, these terms indicate that the acquisition, management and disposition of the income-producing property must closely relate to the taxpayer's regular trade or whole process of operating its business. Further, in our view, the words "acquisition, management, and disposition" suggest elements typically associated with the "keeping" of corporate property, or, as observed in *Kroger*, the "conditions of ownership" of corporate property. 284 Ill.App.3d at 479, 220 Ill. Dec. 566, 673 N.E.2d 710. Thus, interpreting the second clause as a whole, the sale of property will constitute business income if the property and sale are essential to the taxpayer's business operations.

182 Ill.2d 262, 271 [695 N.E.2d 481, 485].

> We find the functional test to be consistent with the above reading of the plain language of the statute. The functional test classifies as business income all gain from the disposition of a capital asset if the asset was "used by the taxpayer in its regular trade or business operations." As discussed previously, the second clause of section 1501(a)(1) focuses upon the role or function of the property as being integral to regular business operations. The use of a capital asset in the taxpayer's regular trade or business indisputably renders that asset an integral part of the taxpayer's regular business operations. *The adoption of the functional test also comports with the legislative history and purpose behind the Act. The test was adopted directly from the comments underlying the UDITPA, which predate the enactment of our act,* and which state that "[i]ncome from the disposition of property used in a trade or business of the taxpayer is includible within the meaning of business income." Uniform Division of Income for Tax Purposes Act, 7A U.L.A. § 1, Comment (1966), reprinted in 2 Multistate Corporate Income Tax Guide (CCH) par. 8805. The test also is supported by regulations promulgated by the Department, which, although not binding upon us (*Canteen*, 123 Ill.2d at 104-05, 121 Ill. Dec. 267, 525 N.E.2d 73), are entitled to substantial deference. See 86 Ill. Adm. Code §§100.3010(a), (d)(3) (1996). In particular, section 100.3010(d)(3) classifies as business income capital gain from assets which, while owned by the taxpayer, were "used in its trade or business."

182 Ill.2d 262, 272 [695 N.E.2d 481, 486]. (Emphasis added.)

The court distinguished *Laurel Pipe Line Co.* v. *Commonwealth, Bd. of Finance and Revenue*, 537 Pa. 205 [642 A.2d 472] (1994) (NO. 91 M.D. 1992) stating there was no evidence that the sale meant a complete cessation by Texaco-Cities of "a 'separate and distinct aspect' of [the taxpayer's] business, namely, all of its pipeline operations in a specific geographical region,"[9] and further that the proceeds from the sale were put back into the business and not distributed to Texaco-Cities' shareholders. 182 Ill.2d 262, 274 [695 N.E.2d 481 at 487].

In a recent California decision, *Citicorp North America, Inc*. v. *Franchise Tax Board*, -- Cal. App. 4th – [-- Cal. Rptr. 2d --; 2000 Cal. App. LEXIS 773, at 47-48] (1st App. Dist. No. A086925; Oct. 2, 2000) (see discussion, *infra*), the California Court of Appeal left undetermined whether or not two separate tests exist, concluding: "The resolution of the issue of whether there are two tests is unnecessary in this case, because the questioned gain on sales produced business income under either the transactional or functional test."

Who is Right -- the Twenty-Eight States That Construe The Definition as Having Two Alternative Tests, or the Few Courts Construing Only One?

In Chapter Nine of their treatise, the Hellersteins appear to agree with the taxpayer's arguments in *Texaco-Cities*, namely that the language contained in the second phrase of the business income definition is a "subset" of the first phrase and does not enlarge the language of the first phrase.[10] Thus, business income is income arising from transactions and activities in the regular course of the taxpayer's trade or business. Those transactions or activities include income from tangible and intangible property if the acquisition, management, and disposition of the tangible or intangible property was an integral part of the taxpayer's regular trade or business operations. Thus, the Professors Hellerstein assert that the business income definition must be statutorily amended to properly include the functional test:

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[9] The taxpayer filed a Motion for Reconsideration and raised as its main point the issue that *Laurel Pipe Line* could not be distinguished, and the Illinois Court denied the Motion.

[10] Some state supreme courts have read the second clause of UDITPA as simply modifying the first clause, and therefore have held that the definition of business income under UDITPA contains only the transactional test. See, e.g., *Phillips Petroleum Co.* v. *Iowa Dep't of Revenue & Fin.*, 511 N.W.2d 608 (Iowa 1993); *In re Appeal of Chief Indus.*, 255 Kan. 640 [875 P.2d 278]; *Federated Stores Realty* v. *Huddleston*, 852 S.W.2d 206 (Tenn.1992). However, after these decisions, the legislatures of those states promptly amended their respective tax statutes to explicitly include the functional test within their definition of business income. See Act of May 1, 1995, ch. 141, § 1, 1995 Iowa Acts 256, 256 (effective retroactive to Jan. 1, 1995); Act of May 17, 1996, ch. 264, § 1, 1996 Kan. Sess. Laws 1868, 1868; Act of May 6, 1993, ch. 182, § 1, 2, 1993 Tenn. Pub. Acts 442, 442. *Polaroid* v. *Offerman*, 349 N.C.290, 295 [507 S.E.2d 284, 289] (1998). The same is true of New Mexico after the decision in *McVean & Barlow, Inc.* v. *New Mexico Bureau of Revenue*, 88 N.M. 521 [543 P.2d 489] (Ct. App.), cert. denied, 89 N.M.6 [546 P.2d 71] (1975). N.M. Stat. Ann. 1978 § 7-4-2. Tennessee's and New Mexico's amendments struck the word "and" and substituted the word "or" in the second phrase of the business income definition. Iowa left the conjunction in and added examples of "dispositions" that would be considered business income. See Iowa Code § 422.32.2:

> gain or loss resulting from sale . . . or other disposition of real property or tangible or intangible personal property, if the property while owned by the taxpayer was operationally related to the taxpayer's trade or business carried on in Iowa or operationally related to sources within Iowa, or the property was operationally related to sources outside this state and to taxpayer's trade or business carried on in Iowa . . . .

> The language of UDITPA, after all, says that business income "includes income from tangible and intangible property if the acquisition, management, *and* disposition of the property constitute integral parts of taxpayer's regular trade or business." The plain language of the statute thus requires that the "disposition" (as well as the acquisition and management) of the property constitute an integral part of taxpayer's trade or business. If the transaction is an extraordinary one, it is hard to see how the disposition can constitute an integral part of taxpayer's regular trade or business.

J.R. HELLERSTEIN AND W. HELLERSTEIN, STATE TAXATION: CONSTITUTIONAL LIMITATIONS AND CORPORATE INCOME AND FRANCHISE TAXES, 3D ED., ¶9.05[2][c] (West 2000).

The Professors believe that regardless of the history of UDITPA, or the comments and regulations on the subject, UDITPA itself does not authorize the "functional test," that the comments and regulations cannot alter that outcome, and that the correct approach is that of Tennessee in amending its statute by substituting the word "or" for "and":

> "Business earnings" mean earnings arising from transactions and activity in the regular course of the taxpayer's trade or business *or* earnings from tangible and intangible property if the acquisition, use, management *or* disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. In essence, earnings which arise from the conduct of the trade or trades or business operations of a taxpayer are "business earnings," and the taxpayer must show by clear and cogent evidence that particular earnings are classifiable as nonbusiness earnings. A taxpayer may have more than one (1) regular trade or business in determining whether income is "business earnings." This subdivision expresses the legislative intent to implement and clarify the distinctions between business and nonbusiness earnings, as found in the Uniform Division of Income for Tax Purposes Act, as generally interpreted by states adopting the act.

Tenn. Code Ann. § 67-4-2004 (1999). (Emphasis added.)

As of the writing of this presentation, namely September 8, 2000, however, twenty-eight states retain both tests and have not changed their statutes: Alaska, Arizona, Arkansas, California, Colorado, (District of Columbia), Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Mississippi, Missouri, Montana, Nebraska, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Tennessee, Utah, and Wisconsin. Are all these states wrong? Further, in those states whose courts have construed the definition as only containing one test, the legislature rushed to change the law to include both tests. See discussion, *supra*. Now, what about *Uniroyal*?

The court in *Ex Parte Uniroyal Tire Company*, Docket No. 1981928, Supreme Court of Alabama (August 4, 2000) (see discussion, *infra*), in analyzing the sale of a partnership interest, quoted from *General Care* v. *Huddleston*, 705 S.W.2d 642, at 648 (1986): "The literal terms of the stat-

ute[11] cannot be read to make the integral role of an asset in the taxpayer's business the controlling factor by which business earnings are identified without doing violence to the elementary rules of grammar." Further, the Alabama Supreme Court found troubling the fact that the second phrase is written in the conjunctive and not in the disjunctive. The court, after citing to a law review article,[12] Peter Faber's 1995 article[13], and Professors Hellerstein, concluded that it could not substitute "or" for "and" in the second phrase of the definition of business income. As a result, it concluded that no alternate, functional test exists. Any other construction, the court held, would render the functional test so broad as to swallow or render a nullity the transactional test. It should be noted that the Alabama Supreme Court had before it Alabama's regulation (identical to MTC Reg. IV) and concluded that to hold that the regulation interpreting the statute contains two separate tests for determining business income would conflict with the plain meaning of the statute.[14]

This opinion seems to be disingenuous in the least, and/or simply wrong at worst. The court discards sacrosanct rules of statutory construction (i.e., why would the language be there if it renders the remainder of the statute a nullity?) and ignores the voluminous legislative history of Section IV of UDITPA (which Alabama adopted without change). The functional test on its own does not "swallow" or engulf the transactional test. The transactional test includes all of those *transactions and activities* in a taxpayer's ordinary course of business, the *day-to-day business, what you sell, how you sell it, etc.* The functional test is, if you will, an "ownership test" involving all *tangible and intangible property (not services) used to make the sales.*

B. Federal Income Tax Analogies to Business vs. Nonbusiness Characterization of Income and Deductions[15]

There is a substantial and authoritative body of federal income tax case law decided under Section 162 of the Internal Revenue Code in the context of deciding whether a corporation is entitled to deduct expenses as a cost of conducting its "business" or whether it must instead capitalize them.

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[11] Ala. Code § 40-27-1 provides:

> "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

[12] Dan A. Lisonbee, *State of the Law of Nonbusiness Gain* 7 J. ST. TAX. 333, 335-36 (1989).

[13] Peter Faber, *When Does the Sale of Corporate Assets Produce Business Income for State Corporate Franchise Tax Purposes?*, THE TAX EXECUTIVE 179 (May-June 1995).

[14] Ironically, the court noted the use of "and" or "or" by the legislature was not conclusive as to the legislature's intent; and that a court could indeed substitute an "or" for an "and." But, it then went on to conclude that, in this case, to do so would be to render the transactional test a nullity.

[15] Authored by Glenn Smith.

The term "business," as used in Internal Revenue Code section 162(a), has the same meaning as the term "business" used in California Revenue and Taxation Code section 25120(a). The technical connection is that Section 162 of the Internal Revenue Code is "substantially similar" to Revenue and Taxation Code section 24343, which governs "business" expense deductions for California franchise tax purposes.[16] Since the same term is deemed to have the same meaning when used in the same statute,[17] the term "business" as used in section 24343 must similarly correspond to the term "business" as used in section 25120(a). The conclusion of this chain of reasoning is that activities that are not treated as being part of a "business" under Internal Revenue section 162 are also not part of a "business" for purposes of Revenue and Taxation Code section 25120(a).

A lead federal income tax case distinguishing business from capital expenses is *INDOPCO, Inc.* v. *Commissioner*, 503 U.S. 79 (1992). The expenses in *INDOPCO* were investment banking and other fees incurred in the "friendly" takeover of the taxpayer. The taxpayer argued that they should be deductible as "ordinary and necessary" expenses of carrying on its business. The U.S. Supreme Court held that the expenses were instead to be capitalized, because they created a beneficial change in corporate structure that extended over several years. In so holding, the Court summarized relevant federal case law as follows (503 U.S. at 89-90):

> Courts long have recognized that expenses such as these, "'incurred for the purpose of changing the corporate structure for the benefit of future operations, are not ordinary and necessary business expenses.'" *General Bancshares Corp. v. Commissioner*, 326 F.2d, at 715 (quoting *Farmers Union Corp. v. Commissioner*, 300 F.2d 197, 200 (CA9), cert. denied, 371 U.S. 861 (1962)). See also B. Bittker & J. Eustice, Federal Income Taxation of Corporations and Shareholders, pp. 5-33 to 5-36(5th ed. 1987) (describing "well- established rule" that expenses incurred in reorganizing or restructuring corporate entity are not deductible under section 162(a)). Deductions for professional expenses thus have been disallowed in a wide variety of cases concerning changes in corporate structure. [Footnote omitted.] Although support for these decisions can be found in the specific terms of section 162(a), which require that deductible expenses be "ordinary and necessary" and incurred "in carrying on any trade or business,"[8] courts more frequently have characterized an expenditure as capital in nature because "the purpose for which the expenditure is made has to do with the corporation's operations and

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[16] The "substantial similar[ity]" of these statutes was recognized by the State Board of Equalization in *Appeals of Cioco Union Stores, Inc.* (1987) Cal. St. Bd. of Equal., CCH California Tax Reporter ¶ 205-546, at p. 14,893-59:

> Section 24343 permits the deduction of "all ordinary and necessary expenses paid or incurred . . . in carrying on any trade or business." The section is substantially identical to its federal counterpart, section 162 of the Internal Revenue Code. Under such circumstances, the interpretation and effect given the federal statute are highly persuasive with respect to proper application of the state law. (Meanley v. McColgan, 49 Cal.App.2d 203, 209 [(1942)]; Rihn v. Franchise Tax Board, 131 Cal.App.2d 356, 360 [(1969)].

[17] "'It is a familiar principle of construction that a word repeatedly used in a statute will be presumed to bear the same meaning throughout the statute . . . .'" *Metromedia, Inc.* v. *City of San Diego,* 32 Cal. 3d 180, 189 (1982), citing *Pitte* v. *Shipley,* 46 Cal. 154, 160 (1873), and *Corey* v. *Knight,* 150 Cal.App.2d 671, 680 (1957).

> betterment, sometimes with a continuing capital asset, for the duration of its existence or for the indefinite future or for a time somewhat longer than the current taxable year." *General Bancshares Corp. v. Commissioner*, 326 F.2d, at 715. See also *Mills Estate, Inc. v. Commissioner*, 206 F.2d 244,246 (CA2 1953). The rationale behind these decisions applies equally to the professional charges at issue in this case.

[8] See, *e.g., Motion Picture Capital Corp. v. Commissioner*, 80 F.2d 872, 873-874 (CA2 1936) (recognizing that expenses may be "ordinary and necessary" to corporate merger, and that mergers may be "ordinary and necessary business occurrences," but declining to find that merger is part of "ordinary and necessary business activities," and concluding that expenses are therefore not deductible); Greenstein, The Deductibility of Takeover Costs After *National Starch*, 69 Taxes 48, 49 (1991) (expenses incurred to facilitate transfer of business ownership do not satisfy the "carrying on [a] trade or business" requirement of section 162(a)).

The indication in *INDOPCO* that capitalized expenses may be regarded as simply not part of a taxpayer's "ordinary" business operations has clear implications for the business/nonbusiness distinction in section 25120. For example, support for the Court of Appeal's decision in *Robert Half International, Inc*. v. *Franchise Tax Board*, 66 Cal. App. 4th 1020 (1st App. Dist. 1998) (see discussion, *infra*), may be found in *Bilar Tool & Die Corporation* v. *Commissioner*, 530 F.2d 708 (6th Cir. 1976), cited in footnote 7 of *INDOPCO*, 503 U.S. at 89. In *Bilar*, the taxpayer corporation underwent a change in capital structure—a corporate reorganization—to eliminate shareholder dissension that was threatening to "wreck" (530 F.2d at p. 713) the corporate business. The taxpayer sought to deduct the legal fees it incurred to effect the reorganization, on the ground that the expenses had been necessary to keep the business from going "down the drain." 530 F.2d at p. 711. Notwithstanding the direct connection of the expenses to the health of the regular operations of the business, the court held that the expenses had *not* been incurred in "carrying on any . . . business":

> The attorney fees were expenditures for devising and carrying out the "unified plan" [of reorganization]. *They were not "incurred . . . in carrying on any trade or business*." They were not "ordinary or necessary expenses." They were of benefit to the whole of the original corporation because they served the purpose of terminating the dissension which threatened to wreck it. They were likewise of capital benefit to both successor corporations, since they were essential to making both possible. . . . [Emphasis added.]

See also Mills Estate v. *Commissioner*, 206 F.2d 244, 246 (2d Cir. 1953).

III. Recent and Pending Cases

A. *Firstar Corp.* v. *Commissioner of Revenue*[18] 575 N.W.2d 835 (Minn. 1998)

[18] Authored by Deborah Mayer.

In *Firstar Corporation v. Commissioner of Revenue*, a "once-in-a-lifetime" sale of executive headquarters in Milwaukee, Wisconsin, resulting in a gain of $195 million was determined to generate nonbusiness income where it was an infrequent, irregular transaction; there was no such former business practice; and the subsequent use of the proceeds was only an "indirect benefit to taxpayer's ongoing business." In interpreting the applicable Minnesota statute after repeal of the UDITPA definition of business and nonbusiness income, the Minnesota Supreme Court held that the new definition was not intended to be more expansive and the only appropriate test to apply was the transactional test.

Minnesota Statutes section 290.17, subdivisions 2(f), 3, and 6, were at issue in this case. This statutory language provides that nonbusiness income is assigned to the taxpayer's domicile and is not apportionable to Minnesota. Although Minnesota Statutes section 290.17 still differentiated between business and nonbusiness income, the legislature enacted no new section defining business and nonbusiness income to replace the deleted definitional section contained in Article IV. The tax court concluded that the repeal of Article IV also resulted in the rejection of UDITPA's definition of business income in Minnesota, stating without any further explanation that "Minnesota has a more expansive definition of apportionable business income." In the words of the Supreme Court of Minnesota:

> While the exact UDITPA language defining business and nonbusiness income is no longer part of the statute, the fact that Minn. Stat. § 290.17 still differentiates between the two types of income indicates the legislature's continuing intent to tax only that portion of a taxpayer's income generated from carrying on a trade or business. Upon comparison of the UDITPA definitions of business and nonbusiness income and the language contained in Minn. Stat. § 290.17, subd. 3, we can draw no meaningful distinction between income "arising from transactions and activity in the regular course of the taxpayer's trade or business" and income "derived from carrying on a trade or business." Accordingly, we conclude that Minnesota's current definition of business income is not any more expansive than the definition contained in UDITPA, despite the 1987 repeal of Article IV.

Minnesota Statutes section 290.17, subdivision .3 (1999) was subsequently amended to drop both tests and provide that business income is all income except for nonbusiness income. Nonbusiness income is defined as “income of the trade or business that cannot be apportioned by this state because of the United States Constitution or the constitution of the state of Minnesota and includes income that cannot be constitutionally apportioned to this state because it is derived from a capital transaction that solely serves an investment function.” Minn. Stat. § 290.17, subd. 6 (1999).

B. *Robert Half International* v. *Franchise Tax Board*[19] 66 Cal. App. 4th 1020 (1st App. Dist. 1998)

Robert Half International is the first California appellate court to address squarely the meaning and scope of the functional test. The case involved the California franchise tax treatment of the

[19] Authored by Glenn Smith.

cancellation of a warrant assumed by a corporation in the course of a corporate merger.

The facts in *Robert Half* are compact. In January 1980, a California-domiciled corporation named Boothe Financial Corporation ("Boothe")[20] acquired another corporation, the IDS Realty Trust (the "Trust") by means of a statutory merger. Both Boothe and the Trust were publicly traded. The Trust had previously issued a warrant to acquire shares of its stock. The warrant was held by a third party. In the merger, the warrant became a warrant to acquire 480,000 shares of Boothe stock. If exercised in full, the warrant would become shares representing about 21 percent of the voting power in Boothe.

Boothe had undertaken the merger principally to acquire the real estate business and assets of the Trust. After the merger, Boothe's principal businesses were real estate development and the leasing and sale of computer equipment.

Boothe became concerned about the effect the warrant was having on the public market for Boothe's shares. Because Boothe's shares were widely held, a concentrated block of 21 percent could have amounted to practical control of the company. As a result, in February 1981, Boothe paid the owner of the warrant $7.5 million to cancel it.

Boothe claimed the $7.5 million as a nonbusiness loss under section 25120(a) allocable solely to California for California franchise tax purposes. The Franchise Tax Board disagreed. Boothe appealed to the State Board of Equalization, which in a summary unpublished opinion, held for the Franchise Tax Board on the authority of *Appeal of DPF Incorporated*, Cal. St. Bd. of Equal., Oct. 28, 1980, CCH Cal. Tax Rptr. ¶ 206-430.[21]

Boothe paid the tax and interest, and sued for a refund. At trial, Boothe and the Franchise Tax Board filed cross-motions for summary judgment. The trial court ruled in the Franchise Tax Board's favor, also in reliance upon *Appeal of DPF*.

Boothe appealed. The Court of Appeal reversed the trial court and held the loss to have been nonbusiness in character. Boothe and the Franchise Tax Board agreed on two points that consid-

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[20] Boothe was later renamed Robert Half International. To reduce confusion, the taxpayer in *Robert Half* will be referred to as consistently as possible in this discussion as "Boothe."

[21] The taxpayer in *Appeal of DPF* had issued debentures and deducted the interest expense as a business deduction. As interest rates increased, the market value of the debentures decreased, and the taxpayer bought some of them in, and thereby realized a taxable gain, since it paid less than it had received when it issued the debentures. The taxpayer treated the income as nonbusiness income allocable in full to its commercial domicile in New York. The State Board of Equalization held, in part, that the taxpayer's activities with respect to its outstanding debt securities constituted an integral part of its trade or business:

> In this context, we think the acquisition, management and disposition of its own securities by a taxpayer engaged in a single trade or business constitute integral parts of that trade or business, giving rise to business income. This is true even though the transactions involving its own securities might be occasional or extraordinary events (Appeal of Borden, Inc., supra), and it is the only conclusion consistent with appellant's treatment of the interest paid to debenture holders as a deductible expense of its unitary leasing business.

erably sharpened the issues for the Court of Appeal. First, they agreed that Boothe's $7.5 million loss did *not* constitute a business loss under the transactional test. They also agreed that the functional test is a separate test.

The Court of Appeal focused upon the last ten words of the functional test. Under the functional test, business income

> includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute *integral parts of the taxpayer's regular trade or business operations* [Emphasis added.]

and nonbusiness income is all income other than business income. The Court of Appeal limited its inquiry to whether Boothe's payment to cancel the warrant was an integral part of Boothe's "regular" business operations. 66 Cal. App. 4th, at 1024. The court concluded that Boothe was not in the business of acquiring warrants and that since exercise of the warrant to acquire a "substantial (and perhaps controlling) block of Boothe's stock" would itself be an "extraordinary" (*i.e.*, non-"regular") event, cancellation of the warrant was also an extraordinary event.

The Court of Appeal cited with approval the decision of the Iowa Supreme Court in *Phillips Petroleum Co*. v. *Iowa Department of Revenue*, 511 N.W.2d 608 (1993). In *Phillips Petroleum*, the taxpayer, threatened by a hostile takeover, had borrowed money to redeem a large number of its outstanding shares. It then sold some of its oil properties to fund repayment of the debt. Phillips reported the gain as nonbusiness income, the Iowa tax authority asserted that it was business income, and the Iowa Supreme Court held in the taxpayer's favor. The Iowa court's rationale was that the sale of the oil properties

> was irregular, not only in scope, but also in its nature. It did not occur as an accommodation of Phillips' petroleum production. Rather the transaction was aimed at a wholesale restructuring of the corporation's capital structure.

Id., at 611; quoted in *Robert Half* at 66 Cal. App. 4th at 1025.

In response to a petition for rehearing filed by the Franchise Tax Board, the Court of Appeal added a footnote (footnote 4, 66 Cal. App. 4th at 1025) pointing out that its decision dealt with *deductions* not arising in the regular course of business, not with *income*:

> Because the issue is not presented in this case, we state no opinion on whether income that arises when a taxpayer sells property that it used in its regular trade or business operations should be characterized as business or non business. (Cf. *Laurel Pipe Line Co. v. Com.* (1994) 537 Pa. 205 [64 A.2d 472, 475] [nonbusiness income] with *Texaco–Cities Service Pipeline v. McGaw* (1998) 182 Ill.2d 262 [230 I..Dec. 991, 695 N.E.2d 481, 484-487] [business income].) We also state no opinion on the corollary rule that is applied in states that have adopted the latter position; i.e., that the infrequency or extraordinary nature of the sale is irrelevant. (See *District of Columbia v. Pierce Associates* (App.D.C. 1983) 462 A.2d 1129, 1131.)

The Court of Appeal in *Robert Half* rejected several other arguments advanced by the Franchise Tax Board. The Franchise Tax Board argued that the warrant loss should be considered business in character under the Board's regulations, section 25120, which generally provide that "all transactions . . which are dependent upon or contribute to the operations of the taxpayer's economic enterprise as a whole . . . will be transactions . . . arising in the regular course of, and will constitute integral parts of, a trade or business." The Court of Appeal held that the Franchise Tax Board's interpretation of this regulation would mean that *no* income or deductions could be nonbusiness in character, since in some sense all activity contributes to a taxpayer's business in some fashion.

The Franchise Tax Board argued that *Times Mirror Co.* v. *Franchise Tax Board,* 102 Cal. App. 3d 872 (1980), should cause the warrant loss to be considered a business loss. In *Times Mirror,* the taxpayer disposed of all of the stock in a subsidiary and reported the gain as business income; the Franchise Tax Board had argued for nonbusiness treatment. The Court of Appeal noted that the parties in *Times Mirror* had stipulated that the subsidiary had been acquired and operated as part of the taxpayer's regular business operations, which the Court of Appeal in *Robert Half* found dispositive.

The Franchise Tax Board also cited *Appeal of DPF* in support of business treatment, arguing that *Appeal of DPF* establishes that "when a corporation makes money by buying or selling its own stock, business income results." 66 Cal. App. 4th at 1027. The Court of Appeal found that this proposition "may be true under some circumstances, but it is not necessarily true in others." *Id.* The court reiterated that the circumstances of the Boothe warrant loss merited nonbusiness treatment. An intriguing issue is thus the fate and status of *Appeal of DPF*, since the Franchise Tax Board argued, and the Court of Appeal did not rule out, that some dealings by a corporation in its own stock might be treated as part of its regular business operations.

Both in its petition for rehearing and in subsequent letters to the California Supreme Court, the Franchise Tax Board argued that the Court of Appeal's decision should be de-published. Both courts declined to take that action.

C. *Polaroid Corp*. v. *Offerman*[22] 349 N.C. 290 [507 S.E.2d 284] (1998), cert. denied, 119 S. Ct. 1576 (1999)

In *Polaroid Corp*. v. *Offerman*, 349 N.C. 290 [507 S.E.2d 284] (1998), cert. denied, -- U.S. --, 119 S. Ct. 1576 (1999), the North Carolina Supreme Court ruled that the statutory definition of business income includes both a transactional test and a functional test. It concluded that not only does business income include those transactions occurring in the regular course of business, but also includes income from other events so long as the asset that produces the income constitutes an integral part of the corporation's regular trade or business.

In a successful patent infringement action against Eastman Kodak Company, Polaroid was

[22] Authored by Jack Harper.

awarded and ultimately collected $924 million in damages.[23] On its 1991 North Carolina corporate income tax return, it classified the award as nonbusiness income under North Carolina General Statutes section 105-130.4(a)(1), allocating the entire judgment to its commercial domicile, Massachusetts.[24] The North Carolina Department of Revenue reclassified the award as apportionable business income.

North Carolina General Statutes section 105-130.4(a)(1) provides that business income is:

> income arising from transactions and activity in the regular course of the corporation's trade or business and includes income from tangible and intangible property if the acquisition, management, and/or disposition of the property constitute integral parts of the corporation's regular trade or business operations.

The court distinguished North Carolina's definition of business income from the definition found in UDITPA.[25] North Carolina's definition reads "acquisition management, and/or disposition of the property" as opposed to UDITPA's definition which uses the conjunction "and" instead of "and/or". This distinction would prove pivotal in the case.

The first clause, the transactional test, in determining business income (i.e., looking to the frequency and regularity of similar transactions) was never an issue in the case. The debate centered on whether the second clause in the definition modified the transactional test by providing examples, or whether the second clause established an independent functional test for business income.[26] The court rejected Polaroid's argument that the second clause modified the transactional test and accepted the Department's argument that the phrase "and/or" should be viewed as a compound predicate setting forth an independent functional test. Therefore, it quickly concluded that the business income definition included two separate tests set forth in both the first and second clauses.

In finding further support for a functional test, the court relied on the North Carolina Corporate Income Tax Act's modified adoption of UDITPA and the origins of UDITPA's definition stem-

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[23] The final order awarded Polaroid damages of $233,055,432 for "lost profits" and an additional $204,467,854 for "lost profits" based on a "reasonable royalty" and prejudgment interest of $435,635,685.

[24] None of Polaroid's infringed-upon patents were utilized in North Carolina; none of Polaroid's property or personnel relating to the lawsuit were located in the state; and the judgment proceeds were not utilized in the regular course of its business conducted in North Carolina.

[25] The court noted that North Carolina's Corporate Income Tax Act is modeled after UDITPA. *National Serv. Industries* v. *Powers*, 98 N.C. App. 504 [391 S.E.2d 509], appeal dismissed and disc. rev. denied, 327 N.C. 431 [395 S.E.2d 685] (1990). It also mentioned North Carolina's commitment as an associate member to the Multistate Tax Commission, the MTC's goal of state tax uniformity, and the MTC's adoption of UDITPA.

[26] *National Services Industries* was the only previous North Carolina case that addressed the business income issue. In that case, the court held that if the return on a taxpayer's investment is an integral part of the taxpayer's trade or business (in this case, producing working capital and increasing cash flow), then the income constituted business income. The decision did not address whether the business income definition contained a separate functional test.

ming from California jurisprudence.[27] In this regard, the court concluded that the UDITPA definition as written included both a transactional and functional test.

Finding a functional test in North Carolina's definition of business income, the court then focused on whether the award constituted business income under that test. The court held that the patents were integral income producing assets and "once a corporation's assets [are] found to constitute integral parts of the corporation's regular trade or business, income arising from the acquisition, management, and/or disposition of those assets constitutes business income regardless of how that income is received." Consequently, the *income* from disposition of the patents was as much an integral part of Polaroid's regular business operations for purposes of the business income definition as the initial acquisition and use of the patents. Neither the "disposition" of the patents nor the recovery of lawsuit proceeds was the activity upon which the court focused. Rather, the court focused on the patents that were used in the trade or business and held that any income earned relating to the patents, no matter how far removed, will produce business income. The manner in which the income is received does not matter, so long as the assets themselves are an integral part of the business, and income generated on account of them will be considered business income under the functional test.[28]

The court further reasoned that a portion of the patent infringement proceeds constituted business income because they were partially awarded "in lieu of profits."[29] Since those profits would have been treated as business income if received in the normal course of business, then any compensation received in lieu of those profits should likewise be treated as business income. With regard to that portion of the award that represented "reasonable royalties," the court determined that in essence they amounted to "lost profits" and also constituted business income. The interest component of the award was similarly held to constitute business income under this "in lieu of" theory.

In a surprising footnote, the court indicated that liquidation cases may not be viewed in that same light because liquidation transactions involve ceasing the business rather than furthering the business. Therefore, even though the assets disposed of are integral to the business, the court implied that income from liquidation may not necessarily be classified as business income.

This footnote is revisited in the discussion of *Lenox, Inc.* v. *Offerman, infra*.

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[27] Citing James H. Peters, *The Distinction Between Business and NonBusiness Income*, 25 S. CAL. TAX INST. 251, 272 (1973), which referenced an amendment to the original draft of UDITPA's definition distinguishing business and nonbusiness income suggested by the state of California. Also citing *Appeal of Borden, Inc.*, Cal. St. Bd. of Equal., Cal. Tax Rep. (CCH) ¶ 205-616 (Feb. 3, 1997), finding that California regulations interpreting the uniform definition include a functional test.

[28] As an analogy, the court cited *Simpson Timber*, 326 Or. 370 [953 P.2d 366], where proceeds from government condemnation of timberland were regarded as business income when the underlying timber was used in the taxpayer's business operations.

[29] Relying on *Dover Corp.* v. *Department of Revenue*, 271 Ill. App. 3d 700, 208 Ill. Dec. 167 [648 N.E.2d 1089], appeal denied, 163 Ill. 2d 552, 212 Ill. Dec. 417 [657 N.E.2d 618] (1995), and *United States* v. *Safety Car Heating & Lighting Co.*, 297 U.S. 88 (1936).

D. *Union Carbide Corp.* v. *Offerman*[30] 351 N.C. 310 [526 S.E.2d 167] (2000)

Having found that the statutory definition of business income does include a separate functional test, the North Carolina Supreme Court applied that test in ruling that a reversion of funds from an overfunded pension plan does not constitutes business income.

In 1984, Union Carbide adopted a restructuring plan in order to prevent a hostile takeover. Part of the plan consisted of "spinning off" excess funds from the pension plan to shareholders in an attempt to increase its stock price as a result of the fallout from a catastrophic gas leak at its plant in Bhopal India. In 1985, Union Carbide obtained permission from the Internal Revenue Service to cause a reversion of excess funds from its defined benefit pension plan. A portion of the reverted funds was used to purchase annuities to pay benefits to retired employees. Another portion, approximately $500 million, reverted to the company and was reported as ordinary income on its federal income tax return. On its 1985 North Carolina corporate income tax return, Union Carbide treated the $500 million as nonbusiness income and allocated the funds entirely to Connecticut, its state of commercial domicile. The North Carolina Department of Revenue reclassified the reverted pension funds as apportionable business income pursuant to North Carolina General Statutes section 105-130.4(i). The court of appeals originally ruled the income was properly classified as nonbusiness income. Upon remand by the North Carolina Supreme Court back to the court of appeals for reconsideration in light of the functional test validated in *Polaroid*, the court of appeals unanimously held that income from the reverted funds was not business income under either the transactional test or the functional test.[31] The North Carolina Supreme Court affirmed that decision.

The court of appeals ruled that the pension reversion was not business income under the transactional test because:

(1) the reversion of excess funds, not the operation of the pension plan created the income;

(2) the removal of the funds from the overfunded pension plan was a rare and extraordinary event; and

(3) no such removal occurred before or since the reversion in 1985.

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[30] Authored by Jack Harper.

[31] Union Carbide paid the tax assessment and sued for refund. The trial court granted Union Carbide's motion for summary judgment. The department appealed to the court of appeals. In an unpublished decision, the court of appeals held that the reverted funds were not business income (*Union Carbide I*), under the transactional test defined in the court of appeals' earlier *Polaroid* decision granting summary judgment in favor of Polaroid which was subsequently reversed by the North Carolina Supreme Court. *Union Carbide I* held that the reversion, an extraordinary event, created the income, and not the operation of the plan. After reversing the court of appeals' *Polaroid* decision, and upon petition by the department, the North Carolina Supreme Court allowed review of *Union Carbide I* for the limited purpose of remanding to the court of appeals for reconsideration in light of the supreme court's decision in *Polaroid* which held the definition of business income included a functional test.

2000 N.C. LEXIS at 20, citing *Union Carbide II.* The court of appeals upon remand also held that the reversion was not business income under the functional test because

(1) Union Carbide did not own any interest in the pension plan trust;

(2) the pension plan, while an aspect of a compensation package, was not essential to Union Carbide's chemical business; and

(3) Union Carbide did not rely on the employee pension plan to create corporate income."

2000 N.C. LEXIS, at 21.

The sole issue before the North Carolina Supreme Court was whether the reversion of pension funds constituted business income under the functional test.

Contingent Property Right

In affirming the court of appeals, the supreme court rationalized that the pension plan was not Union Carbide's property. Union Carbide was merely the plan's sponsor. The language in the definition "acquisition, management, and/or disposition" presupposes the ownership of corporate property. Union Carbide held only a contingent property right in the excess funds of the plan in event of termination. Ownership of this contingent right, according to the court, does not equate to acquiring, managing, and/or disposing of corporate property. Since the plan was not the property of Union Carbide, the court reasoned that ownership of only this contingent right in the excess plan funds (i.e., the actual asset generating the income), is not integral or essential to the business of making and selling chemicals. Therefore the reversion income from such a right could not be business income. The court defined integral as "essential to completeness." *Id.*, at 22.

The court noted that even if it were to assume, *arguendo*, that the pension plan was in fact "property" owned by Union Carbide, it still could not consider the acquisition, management, or disposition of the plan integral or essential to the taxpayer's regular trade or business operations.

Plan Not Integral to Regular Trade or Business

The court acknowledged that the plan does assist in attracting and maintaining employees. However, the court concluded that the plan itself is not essential to the regular chemical making business operations. In reaching this conclusion, the court unaccountably relapsed briefly to a transactional test line of reasoning. It interpreted "regular trade or business operations" as business operations done in a recurring manner, and held that since plan assets were not used to generate income in the regular course of business operations, the income could not be classified as business income. The court then applied a "use of proceeds" test and noted that the plan assets were not used as collateral in borrowing, or used to generate income or working capital in the regular course of business, or relied upon to support research and development or to purchase

equipment, or actively traded. Based on those factors, the court considered the reversion a one-time or non-recurring event, and thus not part of Union Carbide's regular trade or business operations. Despite that transactional test-type analysis, the central component of the court's holding was that the contingent property right in the excess funds was not integral or essential to Union Carbide's core business of chemical making. Since business income could only result from acquiring, managing, and/or disposing of property which is *essential* to the corporation's business, then the reversion of such nonessential assets could not satisfy the functional test for business income.

Using the court's logic, the determination of business income can be made by first identifying the asset that produces the income. In this case the asset was the contingent property right.[32] The next step is determining whether that asset is essential to the corporation's regular business operations. In this case, the court found that neither the contingent property right nor the plan were essential.

Reverted Funds are Investment Income

The court considered the plan assets merely surplus investment assets earmarked for the benefit of Union Carbide's employees that were not currently needed to meet obligations of the plan. Since those investment assets produced the income, then the reversion of those assets constitute investment income properly allocable to the corporation's state of commercial domicile. The court then pointed out that the income was properly reported as investment income in Connecticut, Union Carbide's commercial domicile.

Deductible Pension Contributions

The dissent in the court of appeals decision in *Union Carbide II* contended that the pension reversion constituted business income because (1) compensating employees through pension plans is integral to the operation of a business; (2) the contributions to the plan were deducted as "necessary business expenses" and it is inconsistent to now claim the pension is not necessary to its business; (3) Union Carbide's right to withdraw excess funds and the right to direct investments satisfied the "acquisition/management, and/or disposition" portion of the functional test definition; and (4) fairness dictates a finding of business income because contributions to the plan were deducted against business income.

Part of that dissent was also echoed in the supreme court's dissent. Even though the supreme court's dissent concurred with the majority's finding of nonbusiness income, it believed that part of the reversion represented gains on investment of plan assets and part of the reversion represented a flowback of previously deducted pension contributions from business income. To the extent the contributions were deductible against business income, that portion should correspondingly be returned as business income. The majority decision acknowledged that argument but quickly dismissed it because the record before them did not make the distinction.

[32] Even assuming that Union Carbide owned the plan outright, this court would have determined that the income resulting from the reversion would still be non-business income.

Based on the decision, the department is currently considering whether to allow pension plan contributions as deductible expenses from business income.

E. *Lenox, Inc.* v. *Offerman*[33] No. 97-CVS-206, Granville County Superior Court (1999), appeal pending to North Carolina Court of Appeals (No. CA99-1267)

In *Lenox Inc. v. Offerman*, No.97-CVS-206, Granville County Superior Court (1999), appeal pending to N.C. Court of Appeals (No. CA99-1267), the taxpayer has appealed .an order denying its motion for summary judgment and allowing the department's motion for summary judgment. The issue upon appeal is whether the capital gain on complete liquidation of its separate and distinct operating division should be classified as business or nonbusiness income.

Lenox has multistate operating divisions that engage in the business of manufacturing and selling a variety of consumer products, including fine china, crystal, dinnerware, fine jewelry, and other items. In 1970, Lenox established ArtCarved as a functionally and financially distinct operating division to manufacture and sell fine jewelry.[34] In 1988, Lenox sold all of ArtCarved assets as part of a corporate restructuring plan. The sales proceeds were transferred by wire to Lenox's sole shareholder within 24 hours of the sale. The sale produced a net gain, which Lenox classified as nonbusiness income on its 1988 North Carolina corporate income tax return. The department reclassified the gain as business income.

Separate Liquidation Test

Lenox relies on a footnote in *Polaroid* and claims it sets forth another distinct test in determining business income specifically applicable to liquidation cases.[35] There, the North Carolina Supreme Court stated:

> We do note, however, that cases involving liquidation are in a category by themselves. Indeed, true liquidation cases are inapplicable to these situations because the asset and transactions at issue are not in furtherance of the unitary business, but rather a means of cessation.

Lenox argues that the *Polaroid* decision upholds the department's interpretation of the functional test and also establishes a separate analytical category for applying the functional test to liquidation cases. It further claims that *Polaroid* reconciled the split of authority with other jurisdictions over the definition of business income as applied to liquidation cases.[36]

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[33] Authored by Jack Harper.

[34] ArtCarved maintained its own management and financial systems, and had its own president, CFO, and accounting and human resources staff. ArtCarved also had its own operating and reserve accounts, and administered its own payables and receivables.

[35] *Polaroid*, 349 N.C. at 306, n.6.

[36] In *McVean & Barlow, Inc*. v. *New Mexico*, 453 P.2d 489 (N.M. Ct. App. 1975), the liquidation of a large-diameter pipeline business while continuing to operate a small-diameter pipeline business constituted a partial liquidation of

Lenox also claims that it shares four factors with other cases that classified liquidation gains as nonbusiness income:

(1) The sales proceeds were not used in ongoing business operations.[37]

(2) The ArtCarved Division was a functionally and financially operating division distinct from Lenox and its other businesses.[38]

(3) The liquidation of the ArtCarved division was a partial liquidation and a cessation of business for that operation.[39]

(4) Lenox was not engaged in the business of buying and selling assets or operating divisions.

The department contends that the ArtCarved Division had been an integral part of Lenox's unitary business operations, part of which were conducted in North Carolina. The division was not profitable and Lenox decided to sell it. Prior to the sale, income produced by the division's assets were reported as business income for North Carolina income tax purposes. Expenses incurred by the division were deducted as business expenses. Property of the division was included in the division's property factor for apportioning business income. The department also contends that, contrary to Lenox's claim that the ArtCarved Division was functionally and financially separate, it failed to distinguish administrative expenses from that of its other operations on the tax returns, and did not seek separate accounting for the division. In addition, residual expenses relating to the sale were classified as business expenses. Finally, the department charges inconsistency, in that Lenox sold another operating division at a loss and treated that loss as an apportionable business loss during the same year.

The department argues the gain on sale is apportionable business income because:

(1) The division's assets were integral to Lenox's business operations and *Polaroid* mandates

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the taxpayer's business and a total liquidation of the taxpayer's large-diameter business. The resulting income was classified as nonbusiness income. In *Laurel Pipe Line Co.* v. *Commonwealth, Board of Finance & Revenue*, 642 A.2d 472 (Pa. 1994) (see discussion, *supra*) the taxpayer sold one of its two pipelines while continuing to operate the other. The disposed of pipeline had been idle for over three years prior to the sale. The court held that the disposed of pipeline was not integral to the taxpayer's trade or business. The income from the partial liquidation was treated as nonbusiness income. However, in *Welded Tube Co.* v. *Commonwealth*, 515 A.2d 988 (Pa. Commw. Ct. 1986), there was a finding of business income from selling an idle and unprofitable plant. In *Texaco-Cities* v. *McGaw*, 695 N.E.2d 481 (Ill. 1998), the court classified the gain as business income under the functional test.

[37] Distinguishes *Welded Tube* and *Texaco-Cites*, where the sales proceeds were reinvested in ongoing business operations.

[38] In *McVean* and *Laurel Pipeline*, the courts compared the nature of the terminated business with the business that continued to operate.

[39] Each taxpayer in the cases cited above continued to operate its other lines of business after the partial liquidation.

a finding of business income upon disposition.

(2) Rule 17 NCAC 5C.0703 provides that gain or loss from the sale, exchange, or disposition of property constitutes business income if the property, while owned by the taxpayer, was used to produce business income.[40]

(3) The functional test endorsed by *Polaroid* compels a finding of business income.[41]

The department further contends that the footnote in *Polaroid*, cited by Lenox, is merely dicta and cannot represent precedent. In any event, the department claims, sale of the division did not represent cessation of Lenox's unitary business (after the sale Lenox continued to operate) and cannot be considered a "true liquidation." Therefore, the gain is properly classified as nonbusiness income.

F. *Hercules, Inc.* v. *Department of Revenue*[42]
Circuit Ct. of Cook County, Illinois, County Dep't—Law Div'n, Tax and Miscellaneous Remedies Section (Dkt. No. 96-1-50635 (Jan. 2000)

Hercules surrendered all of its assets, technology, and even its employees in its polypropylene ("PPL") chemical manufacturing business in return for a 50-percent interest in a joint venture to produce PPL. In the fourth year of the joint venture, Hercules surrendered 13 percent of its interest to the joint venture so it could make a public offering, and finally sold its interest a few months later for a substantial gain. On its return filed in Illinois, the taxpayer classified the $1.3 billion gain as nonbusiness income, claiming it was an investment asset, not an operational one. After an audit reclassified the income as business income, the taxpayer filed a protest, and on administrative hearing, the ALJ upheld the audit's reclassification. The ALJ concluded that the gain from the sale of the joint venture interest was business income under both tests:

> This section establishes two tests—the transactional test and the functional test. The transactional test is derived from the first clause . . . the functional test from the second clause . . . . The record indicates that the transactional test has been satisfied . . . . The spin-off of [Hercules'] polypropylene operation to a joint venture with Montedison was not a complete divestiture of such operations and remained operationally connected to Hercules for the entire time Hercules retained an interest in Himont . . . . The formation of Himont was a transaction in

[40] The department contends *Polaroid* considers the rule prima facie correct. *See* 349 N.C. at 303 [507 S.E.2d at 294].

[41] The department claims that *Polaroid* acknowledges California's jurisprudence and its impact on UDITPA, the precursor to North Carolina's business income definition. Therefore, in the department's view, the court should rule consistently with *Appeal of Borden, Inc.*, Cal. St. Bd. of Equal., Cal. Tax Rep. (CCH) ¶ 205-616 (Feb. 3, 1997), in which the SBE held that the portion of the purchase price allocated towards goodwill constituted business income under the functional test. The department also relies on *Appeal of Triangle Publications, Inc.*, 1984 Cal. Tax LEXIS 86, where the gain on the asset sale of two operating divisions was considered business income.

[42] Authored by Deborah Mayer.

> the regular course of the business activities of Hercules, evidenced by the fact that it was one of a succession of at least twenty joint ventures which contributed to its unitary business [citing to Hercules' annual reports and other stipulation exhibits]. Hercules regularly engaged in such joint venture transactions as the one subject herein constituting a systematic and recurrent business practice . . . .
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> The income also clearly meets the functional test . . . . Under the functional test, income from the sale of assets will be considered to be business income if the assets produced business income while owned by the taxpayer, i.e., was the property ever used by the Taxpayer in its regular trade or business operations? [Citing *National Realty & Investment Co*. v. *Department of Revenue*, 144 Ill. App. 3d 541, 554 [494 N.E. 2d 924] (2nd Dist. 1986) and *Dover Corp*. v. *Department of Revenue*, 271 Ill. App. 3d 700, 208 Ill. Dec. 167 [648 N.E.2d 1089] (1st Dist. 1995).] The property was undeniably used for such purposes. To reach this conclusion the issue cannot be viewed simply as the sale of stock . . . . Himont was established less than four years prior to the subject transaction with the transfer by Hercules of its entire polypropylene resins operations . . . . [The transfer did not constitute a complete divestiture of the assets. Rather, the transfer resulted in a change in the form of ownership and management of the operations.] The formation of Himont was effected by the transfer of the polypropylene resins operations from Hercules and Montedison. The transfer to Himont included not only fixed assets . . . but the entire supporting infrastructure of the on-going business operations in the form of management and administrative services including key officers and employees, marketing expertise, contracts, goodwill, patents and technologies. . . . According to extensive testimony, Himont could have functioned without the service contracts with Hercules. But the salient fact is—it didn't.

The taxpayer appealed under the Illinois Administrative Review Act. The circuit court judge granted the taxpayer's motion to reconsider its memorandum decision and order, vacating its decision and order, but upholding the ALJ's decision that Hercules' gain on sale of its joint venture interest in Himont was business income under the functional test, but not under the transactional test. According to the circuit court, Hercules was not in the business of acquiring and disposing of joint ventures. The circuit court held that the gain on the sale was business income only under the functional test because there existed an "operational relationship" between Hercules and Himont. In so concluding, the circuit court relied on the Illinois Supreme Court's decision in *Texaco-Cities Pipeline* v. *McGaw*, 182 Ill. 2d 262 [695 N.E.2d 481] (1998), that "under the functional test, all gain from the disposition of a capital asset is considered business income if the asset disposed of was used by the taxpayer in its regular trade or business operations."

The circuit court reasoned that the joint venture was formed to carry on Hercules' business of manufacturing and marketing aerospace and electronic products, specialty chemical products, and engineered fabricated products. Its joint venture interest in Himont was not a passive investment:

> Thus, interpreting the second clause as a whole, the sale of property will constitute business income if the property and sale are essential to taxpayer's business

operations.

> [I]n 1983, Hercules exchanged tangible personal property for intangible property evidenced by stock representing a 50% interest in Himont . . . . Based on the DOR's regulation the exchange of tangible personal property (polypropylene assets) into stock did not create nonbusiness income . . . [T]o constitute nonbusiness income the tangible personal property must be utilized for the production of nonbusiness income or must be removed from the property factor before the exchange. . . . If anything, the new assets . . . should retain the same identification or characteristic as the assets used in the exchange. . . .

The circuit court judge determined that the stock was an integral part of Hercules' business operations based upon the taxpayer's annual reports, statements by its president; and reports to its shareholders concerning the strategy for restructuring; namely, the enhancement of the value of the PPL business by Hercules' efforts during the years the joint venture existed before its ultimate disposition and by the joint venture agreement itself, disclosing the purpose to form a worldwide joint venture to hold directly or indirectly the PPL assets. After 1983, Hercules remained in the business of manufacturing and marketing PPL not directly, but through the operations of Himont. The joint venture agreement made it clear that Himont was not a passive investment. Both the joint venture agreement and the shareholders' agreement contained restrictive provisions precluding Hercules from disposing of the capital stock for five years without the consent of Montedison. The court concluded that the restrictive provisions of the agreement also demonstrate that the stock was an integral part of Hercules' regular trade or business, serving an operational rather than an investment function:

> The stock was the repository Hercules used in its efforts to reduce its exposure to the petrochemicals and to enhance the value of a segment of its business which it scheduled for ultimate disposition. From the terms of the documents, it appears a period of five years was designated to achieve the desired results.

The fact that Hercules sold a substantial amount of its joint venture interest prior to the final sale to permit Himont to make a public offering did not change the outcome. That "divestiture" was just a way to infuse working capital to Hercules and provided Hercules with incredible flexibility to capture other business opportunities. What was business income to Hercules prior to the public offering remained business income in the hands of Hercules up to the date of the sale of all of its stock ownership. There was an operational function between Hercules and Himont when it surrendered its stock to allow for the initial public offering (that is how Hercules infused capital into Himont), and the PPL assets were not converted to nonbusiness income prior to the exchange pursuant to the DOR's regulation.

The fact that the proceeds were used by Hercules as working capital to pay taxes, redeem its own stock, invest in its aerospace research and development, and upgrade its facilities across the company distinguished it from *Laurel Pipe Line* v. *Commonwealth, Bd. of Finance and Revenue,* 537 Pa. 205 [642 A.2d 472] (1994). The taxpayer failed to meet its burden of proof to show that there were no operational benefits between the parent and the subsidiary.

Taxation of the gain violated neither the Due Process nor Commerce Clauses of the United States Constitution. The court did not separately discuss the tests. It merely found that nexus existed based upon the fact that Hercules' principal business activity in Illinois was the sale of industrial chemicals to Illinois customers. It maintained a sales office in Illinois and a public warehouse in the state. Thus, the gain apportioned to Illinois bore a "rational relationship" to Hercules' business in Illinois, notwithstanding its assertions that its Illinois activity consisted exclusively of marketing. Further, the court noted that by "deferring the capital gains transaction in 1983 and the successful growth of Himont, Hercules placed itself in the present situation."

Hercules retained nexus to Illinois by deferring its capital gain transaction from 1983 to 1987 and offered no proposed alternative apportionment method which would fairly and accurately apportion its income to Illinois based upon its business activities in Illinois, namely the sale of industrial chemicals to Illinois customers and maintenance of both a sales office and warehouse in Illinois. The taxpayer failed to meet its burden of proof to show that there were no operational benefits between the parent and the subsidiary.

The case is now on appeal to the Illinois Appellate Court. The Department of Revenue filed its brief on September 8, 2000. The issue as framed by the department is "[w]hether the Department's determination that the capital gain realized by the taxpayer from the sale of stock in its joint-venture was business income apportionable to Illinois is not clearly erroneous."

The statutes and regulations involved are:

35 ILCS 5/1501(a)(1) of the Illinois Income Tax Act ("IITA") defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business . . . and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Ill. Rev. Stat. ch. 120, ¶ 15-1501(a)(1) (1987) (now codified at 35 ILCS 5/1501(a)(1) (1998)).

Section 100.3050 of Title 86 of the Illinois Administrative Code provides, in relevant part:

> a) [B]usiness income is income arising from transactions and activity in the regular course of a trade or business, . . . and includes income from tangible and intangible property constituting integral parts of a person's regular trade or business operations. . . . . A person's income is business income unless clearly classifiable as nonbusiness income. Nonbusiness income means all income other than business income or compensation. The classification of income by the labels occasionally used, such as manufacturing income, sales income, interest, dividends, rents or royalties, gains and operating income, is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of trade or business operations. Accordingly, the critical element in determining whether income is "business income" or "nonbusiness income" is the identification of the transaction and activity which are the elements of a particular trade or

> business. In general, all transactions and activity which are dependent upon or contribute to the operation of the economic enterprise as a whole will be transactions and activity arising in the regular course of a trade or business.
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> * * * *
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> (c)(4) Examples
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> > (C) Example C: Same facts as Example B [Corporation A owned controlling interest in unitary subsidiaries], except that Corporation A owns only 15% of the outstanding stock of Corporation C. While the activities of Corporation C contribute to and are related to the business activities of the other corporations, it cannot be included in the unitary group for combined apportionment purposes since the requisite ownership is lacking. However, any dividends or other income paid A which arises from A's ownership interest in C will be business income and included in the total combined unitary business income since the acquisition, management, and disposition of Corporation C's stock constitutes an integral part of the business activity conducted by A.

86 Ill. Admin. Code § 100.3050(a), (c)(4)(C) (1985).

In its brief, the department argued that the income was business income under the transactional test:

> Hercules entered in the joint-venture with Montedison to create Himont in order to gain access to advanced technology in polypropylene production, (Vol. 5, C1214), to reduce its risk, and gradually to exit, a business that it felt was too tied to the petroleum price fluctuations, (Vol. 6, C1329, ¶ 19; Vol. 8, C1786; *see, e.g.*, Vol. 9, C2973, C2133). Hercules had a history of entering into similar joint-ventures to advance its business purposes. Hercules' annual reports are replete with references to its successful joint-ventures and indicate that between 1982 and 1987, Hercules entered into about twenty joint-ventures and sold about four of them. (Vol. 9, C2069-2129, 1982 Annual Report; C2130-2179, 1983 Annual Report; C2180-2231, 1984 Annual Report; Vol. 9-10, C2232-2285, 1985 Annual Report; Vol. 10, C2286-2337, 1986 Annual Report; C2238-2388, 1987 Annual Report; Vol. 2, C363-64).
>
> Throughout its annual reports it touts its practice of forming joint-ventures as a regular and effective means of developing or gaining access to new technologies and markets without major capital investments. (*Id.*; *see also* Vol. 10, C2365; Vol. 9, C2133, touting similarity between Himont and another joint-venture known as "Hercofina" which Hercules formed with American Petrofina). The formation and sale of joint-ventures, such as Himont, was a regular business practice and income derived from such sales is business income. *See Atlantic Richfield Co.*, 601 P. 2d at 631-32; *Welded Tube Co.*, 101 Pa. Commw. at 43-44, 515 A.2d at 993-94; *accord Borden*, 295 Ill. App. 3d at 1010-11, 692 N.E.2d at

1341-42 (holding that the gain realized from the sale of subsidiaries as part of a restructuring plan involving the sale of various companies was business income without clearly distinguishing between whether the gain met the transactional or functional test).

That fact that Hercules may have sold Himont to avert a hostile takeover attempt by Montedison, (Vol. 5, C1061-65), is of no import. The fact that the timing of the sale of Himont stock may not have been entirely voluntary does not take the sale out of the regular course of business. *See Simpson Timber Co. v. Department of Revenue*, 326 Ore. 370, 375, 953 P.2d 366, 369 (1998) (Separate Supplemental Appendix at A50-58). "All business is conducted with the knowledge that events beyond the control of those operating the business may affect the plans of the business operators." *Simpson Timber Co.*, 326 Ore. at 375, 953 P.2d at 369. Regardless of whether Montedison forced Himont's hand, the income derived from that sale still constitutes business income. *See, e.g., id.* at 375-76, 953 P. 2d at 369-70 (holding that compensation paid timber company by government through condemnation of timberland qualified as business income); *accord Pennzoil Co.*, 2000 Ore. LEXIS at 12-14 (holding that award of damages via a court's judgment was business income even though taxpayer had to enforce contract by suing third-party tortfeasor).

In the same brief, it also argued that the income satisfied the functional test:

Hercules' investment in Himont was not a passive investment in the stock of an unrelated business. Rather, the formation of the joint-venture was a calculated effort to maximize the productive capacity and profits, while minimizing the risks, involved in running one of Hercules' main lines of business. Himont was an integral part of Hercules' regular business operations, and the capital gain realized from the sale of Himont stock was business income.

In 1981, 1982 and through November 1, 1983, Hercules sold over a $1 billion dollars of polypropylene world-wide. (Vol. 6, C1327, ¶ 13). Further, in 1981, Hercules, itself utilized almost 20% of its own polypropylene production. *(Id.)*.

In 1983, Hercules did not invest in Himont, it created it. In creating Himont, Hercules did not simply purchase stock or other assets in an unrelated business at arm's length in the market place. Rather, it transferred to Himont both tangible and intangible assets essential to running the business. The tangible assets consisted of polypropylene plants and their inventories, work in progress and raw materials. (Vol. 6, C1330-31, ¶ 26). The intangible assets consisted of trademarks, service marks, trade names, logos, slogans, product designs, patents, copyrights, technical information and accounts receivable. (Vol. 6, C1331, ¶ 26). Upon creation, Himont was a fully equipped and completely operational business.

Not only did Hercules transfer tangible and intangible assets but also it transferred considerable management expertise to Himont. According to Di Francesco, Hi-

mont's Vice President and Chief Financial Officer, (Vol. 5, C1211), for the six months prior to Himont's formation, he and a number of other Hercules personnel worked exclusively in setting up Himont's accounting, payroll and other financial systems, (Vol. 5, C1227-29). When Himont was formed, all of Hercules' Plastic Resins Business Center's employees ended their employment with Hercules and became employees of Himont. (Vol. 6, C1331, ¶ 27). Under the shareholders agreement, Hercules selected Himont's President, Vice President of North American Operations, Vice President for Administration and General Counsel, Vice President of Finance, Chief Financial Officer, and Controller. (Vol. 6, C1339, ¶ 56). Further, under the shareholders agreement, Himont's president could not operate freely in selecting his management team but had to consult with Hercules and Montedison before selecting key officials. (Vol. 6, C1339, ¶ 59). Thus, in creating Himont, Hercules contributed the entire supporting infrastructure of an ongoing business operation.

Considerable management services were also transferred back and forth between Hercules and Himont. Through 1987, Hercules continued to provide Himont with accounting, billing, tax preparation, audit, purchasing, personnel, safety, medical, legal, engineering and computer services. (Vol. 6, C1336, ¶ 44, C1253, C1298-1300). Himont also continued to rent space from Hercules in Hercules' corporate headquarters. (Vol. 6, C1336, ¶ 46). Himont relied on software developed by Hercules and Montedison until the latter part of 1987. (Vol. 6, C1300-02).

In turn, Himont continued to provide research and development, safety, operations and some accounting and bookkeeping services to some Hercules facilities. (Vol. 6, C1336, ¶ 45). This arrangement benefited both Hercules and Himont because both were familiar with each other's needs and thus operations could be transferred quickly and without learning time. (Vol. 5, C1054-56; Vol. 6, C1310, C1312-13). Indeed, Di Francesco noted that the two corporations were so close that it was difficult for Himont to create its own corporate culture. (Vol. 6, C1314).

In addition to transferring the assets, management and operations of an ongoing business into the joint-venture, Himont was arranged so that Hercules could not easily divest itself of Himont. The joint-venture and shareholders agreements between Hercules and Montedison restricted each company's transfer of its respective stock and other assets transferred to Himont. (Vol. 6, C1394; Vol. 8, C1775-76). The parties agreed not to sell any stock in Himont for five years, without the other's consent. (Vol. 8, C1775-79). They also agreed to various restrictions on the pledging and other transfers of the stock. (Vol. 8, C1779-82). Finally, the parties agreed to a "right of first refusal" over the selling certain of Himont's significant assets. (Vol. 8, C1782-85).

There were clear advantages to the arrangement. Hercules gained access to state-of-the-art technology, (Vol. 5, C1214), and Montedison achieved access to the world markets, particularly the United States' market of polypropylene, and to

better management techniques, (Vol. 6, C1277-83). Hercules relied on Himont to provide most of the polypropylene it continued to use in its regular business. Under its agreement with Himont, Hercules was obligated to purchase 85% of its polypropylene from Himont prior to 1987. (Vol. 6, C1334, ¶ 42). Starting in 1987, the amount Hercules was required to purchase dropped to 80%. (*Id.*). From 1984 through 1987, Himont sales to Hercules were between $117 million and $146 million per year. (Vol. 6, C1335, ¶ 43). This amounted to 12-13% of Himont's total sales. (*Id.*).

In short, in creating Himont, Hercules was not making an investment in a separate and discrete unrelated business. Himont continued to do exactly what the Polypropylene Resins Business Center did -- manufacture polypropylene for Hercules and the global marketplace. Hercules simply transformed the manner in which it held its polypropylene manufacturing business from a division of its company into a 50% interest in a joint-venture. While Hercules may not have exercised day-to-day oversight of Himont, (Vol. 5, C1232-33), it did not need to. Hercules maintained control over Himont by transferring to Himont management, expertise, shared services and corporate culture. Himont remained an integral part of Hercules' regular business operations. *See Texaco-Cities,* 182 Ill. 2d at 272-73, 695 N.E.2d at 486.

The creation and management of Himont served a business function, as did Himont's disposition. Hercules' business strategy was to reduce its dependence on petroleum related products like polypropylene and to transform itself into an aerospace and specialty chemicals company. (Vol. 6, C1329, ¶ 19; Vol. 9, C2073, C2133). This was to be accomplished not by simply selling off its polypropylene business but by entering into the joint-venture with the contemplation of making a public offering of Himont stock and eventually divesting itself of the manufacturing of polypropylene. (Vol. 6, C1321, ¶ 3; Vol. 8, C1786).

Further, Hercules reinvested the gain in buying back its own stock and reinvesting in its aerospace and specialty chemicals businesses. (Vol. 5, C1067-68, Vol. 6, C1343, ¶ 67; Vol. 10, C2342). Thus, not only was the acquisition and management of Himont part of Hercules' regular business operations but so was the disposition of Himont. The gain realized from the sale of Himont qualifies as business income. *See, e.g., Texaco-Cities*, 182 Ill. 2d at 272-74, 695 N.E.2d at 486-87 (holding that the gain realized from sale of a substantial part of the taxpayer's pipeline, which proceeds were reinvested in the business, was business income); *Borden, Inc.*, 295 Ill. App. 3d at 1010-12, 692 N.E.2d at 1341-42 (holding that the gain realized from the sale of subsidiaries over which the taxpayer exercised operation control and which was used to restructure the corporation pursuant to a corporate plan was business income); *Kroger Co.*, 284 Ill. App. 3d at 477, 482-83, 673 N.E.2d at 712, 715-16 (holding that the sale of leaseholds as part of corporate restructuring movement was business income).

Because of the substantial body of jurisprudence extant in Illinois beginning with *National Re-*

alty and continuing through *Dover, Kroger*, and *Texaco Cities* (cited by the court in *Hercules*), at least in Illinois there is no question that the functional test is a separate test and is clearly included in the definition of business income set forth in UDITPA. Therefore, it is unlikely that the appellate court will reverse the circuit court in *Hercules*.

G. Ex Parte Uniroyal Tire Co.[43]

Appellate Decision:* Uniroyal Tire Co. *v.* State Dep't of Revenue *(Ala. Civ. App. No. 2971007)

At issue in this case was characterization of the gain on sale of a joint venture interest under the functional test. Alabama had adopted the MTC's definition of business income as well as a regulation interpreting the statute stating that a sale constituted business income if the property, while owned by the taxpayer, was used to produce business income. The administrative law judge assigned the case held that the regulation conflicted with the statute, and that the amounts at issue should be characterized as nonbusiness income. On appeal (3-2 decision), the court determined that no conflict existed between the regulation and the statute, and that the gain on sale of the joint venture interest was business income under the functional test when Uniroyal admitted that its partnership interest produced "business income while owned by Uniroyal" (citing *Polaroid* v. *Offerman*, 507 S.E.2d 284 (NC 1998) (see discussion, *supra*)). Uniroyal's contributed assets in return for a 50-percent interest in the joint venture were business income because "[i]n essence, Uniroyal's trade or business was its investment in the partnership. The eventual sale of that interest, which obviously was driven by its desire for cash and profit, was a calculated process to maximize its return on investment."

A strong dissent distinguished *Polaroid* as a case involving assets such as patents which were integral to Polaroid's business and did not involve final sale; and instead cited *General Care Corp.* v. *Olsen*, 705 S.W. 2d 642 (Tenn. 1986) and *Phillips Petroleum Co*. v. *Iowa Dep't of Revenue & Finance*, 511 N.W.2d 608 (Iowa 1994), and concluded that the transactional test is applicable and the gain was nonbusiness income. Further, Alabama's definition of business income was in the conjunctive and not like the statute in North Carolina which is "and/or."

***Supreme Court Decision:* Ex Parte Uniroyal Tire Co. (Re: Uniroyal Tire Company *v.* State Department of Revenue), -- So.2d --, *(Ala. No. 1981928; Aug. 4, 2000, and as amended Aug. 31, 2000) 2000 Ala. LEXIS 338*[44]**

The Supreme Court of Alabama reversed, quoting from its decision in *General Care* v. *Huddleston*, 705 S.W.2d 642, at 648 (1986): "The literal terms of the statute cannot be read to make the integral role of an asset in the taxpayer's business the controlling factor by which business earnings are identified without doing violence to the elementary rules of grammar." Further, the Alabama Supreme Court found troubling the fact that the second phrase is written in the conjunctive and not in the disjunctive. After citing to a law review article, Peter Faber's 1995 article

[43] Authored by Deborah Mayer.

[44] This opinion is subject to correction or revision before publication in the official reporter.

in the TEI publication, and the Hellersteins, the court concluded that it could not substitute "and" for "or" in the second phrase of the definition of business income; therefore, the court held, no alternate, functional test exists. Any other construction would render the functional test so broad as to swallow or render a nullity the transactional test. It should be noted that the Alabama Supreme Court had before it Alabama's regulation (identical to MTC Reg. IV) and concluded that the regulation interpreting the statute containing two separate tests for determining business income conflicted with the plain meaning of the statute.[45]

In forming its opinion, the Alabama Supreme Court relied on two "cardinal rules" of statutory construction:

(1) A revenue statute is construed most strictly against the government in favor of the taxpayer.

This is a "tried and true" rule of construction, but it breaks down when one considers the following example. Suppose the taxpayer was not an out-of-state company but rather was an Alabama domiciled company. Then, suppose the Alabama Department of Revenue had taken the position that the capital gain on the sale of the partnership interest constituted nonbusiness income, would the court have construed the statute the same way?

(2) Alabama's administrative rule is entitled to deference, but should be disregarded if the rule were contrary to statute.

Alabama is a member state of the Multistate Tax Compact. The Multistate Tax Commission under the compact was empowered to promulgate regulations interpreting UDITPA, and did so. In this instance the Alabama Supreme Court sets aside and completely ignored the Comment that was written by the Commissioners who authored UDITPA; a Comment which grew out of a meeting among 17 states' revenue officials and the Commissioners.[46] The Comment states that if an asset was used in business and then is sold for a gain, that gain constitutes business income.[47] That is the wording of the MTC

[45] It is interesting that the court noted that the use of "and" or "or" by the legislature was not conclusive as to the legislature's intent; and that a court could indeed substitute an "or" for an "and." But, it then went on to conclude that in this case to do so was to render the transactional test a nullity.

[46] This information comes from James Peters' files, meetings with Charles Conlon from the National Association of Tax Administrators, Dr. William Pierce (University of Michigan Law School), and John Warren, author of the proposed functional test, then a member of Loeb & Loeb.

[47] SECTION 1. As used in this Act, unless the context otherwise requires:

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

Comment

This definition refers to "the" taxpayer's trade or business as if he had one business. It is not intended by this language to require a taxpayer having several "businesses" to use the same allocation and apportionment methods for

regulation and that is the wording of the Alabama Regulation that the Alabama Supreme Court struck down.[48] That is a lot to bite off for one state supreme court, i.e., ignoring how Commissioners on Uniform State Laws said the statute should be construed. If the MTC is a creature of the compact, and each state member gives the MTC authority to promulgate regulations and interpret the statute, how can a state supreme court act so cavalierly and so apparently in derogation to Alabama's membership as part of the Compact?

H. *Hoechst Celanese Corp.* v. *Franchise Tax Board*[49]
California Supreme Court, No. S085091, pet. for rev. granted March 1, 2000

The taxpayer, a manufacturer and seller of chemicals, fibers, and specialty products, is commercially domiciled in New York but conducts its business operations throughout the United States and the world. In 1947, the taxpayer created and funded a qualified defined benefit pension plan and a trust to receive and invest the taxpayer's contributions as part of its compensation package for its employees. The pension plan was maintained as an inducement to retain current employees and to attract other qualified new employees, thus allowing the taxpayer to retain a qualified and experienced work force, to diminish the amount of employee turnover, and to lower the costs of employee training.

The plan and trust were administered through administrative and investment committees appointed as needed by the taxpayer's board of directors. The administrative committee, which included an officer of the taxpayer, made decisions regarding benefits and "administered the paperwork generated by the Plan." (*Hoechst Celanese Corp.* v. *Franchise Tax Bd.*, California

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the businesses. The language permits separate treatment of different businesses of a single taxpayer. Section 18 clearly permits separate treatment. *Income from the disposition of property used in a trade or business of the taxpayer is includible within the meaning of business income.* (Emphasis added.).

[48] § 40-27-1, Ala. Code 1975 contains the following language: "if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." The Multistate Tax Compact has been in full force and effect in Alabama since the effective date of the recodification of the Alabama Code in 1977. The 1977 recodification of the Alabama Code contained absolutely no condition to the immediate effectiveness of the Tax Compact. The absence of such conditional language evidences clear legislative intent that the Tax Compact be enacted in 1977 and not be contingent upon Congressional approval, and the legislature clearly, and not by implication, repealed the Congressional approval requirement of the 1967 act by excluding it in the 1975 recodification of *State Dept. of Revenue* v. *MGH Management, Inc.,* 627 So.2d 408 (Ala. Civ. App. 1993), certiorari denied.

Reg. § 810-3-31-.02. Determination of Income from Multistate Operations. (1) Taxpayers having income from business activity which is taxable both within and without this state are required to allocate and apportion their taxable income pursuant to the provisions of the Multistate Tax Compact, Chapter 27, Title 40, Code of Alabama 1975. (Adopted eff. 9-30-82; revised eff. 7-27-88; 11-22-96; 6-7-2000.)

Reg. 810-3-31-.02(1)(a)4.(ii) provides: "As a general rule, gain . . . from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used to produce business income."

[49] Authored by Fred Campbell-Craven.

Court of Appeal, Third Appellate District, No. C030702, Dec. 3, 1999 (opinion since vacated by operation of law on acceptance of case by California Supreme Court).) The investment committee, the membership of which included the taxpayer's chief financial officer, controller, and vice president of human resources, supervised and reviewed the financial operations of the trust. As such, the investment committee held the power to appoint and remove trustees and investment managers, as well as establish and amend investment guidelines and pension investment strategies. Although the board of directors (a) received reports on the condition of the plan and trust and (b) had the power to appoint and change the trustee, the trustee—rather than the taxpayer—held title to the investments in the trust. Assets of the plan and trust were not shown on the taxpayer's balance sheet, nor did trust earnings appear on its books of account. Although all trust funds were required to be used for the exclusive benefit of plan members or their beneficiaries, actuarial gains were used to reduce the taxpayer's future contributions to the trust rather than to increase benefits. Annual contributions were set by independent actuaries and drawn from general business earnings, and the taxpayer claimed deductions for the contributions as ordinary and necessary business expenses on its federal and California returns.

The taxpayer revised its pension investment strategy in 1978, a revision that resulted in plan investments exceeding actuarial expectations and the creation of a large surplus in the pension fund. By 1983, the taxpayer determined to use the cash surplus for other corporate purposes rather than leaving it in the plan, and voted to implement a proposed pension plan reversion. In this regard, the taxpayer was motivated by a desire to avoid having surplus in the plan being used in any takeover bid to acquire its stock. In 1984, pursuant to the reversion plan, the taxpayer received $388.8 million in pension reversion funds that it used to carry out a stock redemption program to reduce the number of its outstanding shares.

The taxpayer reported the $388.8 million as miscellaneous income on its 1985 federal return, and as taxable income on its 1985 New York return. Upon audit, the California Franchise Tax Board determined that the pension reversion funds were apportionable business income. The taxpayer's appeal to the State Board of Equalization was unsuccessful, the Board determining that the matter was properly governed by its decision in *Appeal of Kroehler Manufacturing Co.*, Cal. St. Bd. of Equal., Apr. 6, 1977, in which it had treated reverted pension funds as taxable business income under the functional test.

The taxpayer filed suit for refund. The trial court denied the refund, finding that the apportioned share of the pension reversion constituted business income. The court found in its statement of decision that California Revenue and Taxation Code section 25120, subdivision (a), provides for two alternative and independent tests—the transactional test and the functional test—to classify business income;[50] that the pension reversion was business income under the functional test (but not under the transactional test); and that California's taxation of the gain on the pension reversion did not violate the Commerce and Due Process Clauses of the United States Constitution because the trust served an operational function for the taxpayer rather than an investment func-

[50] California Revenue and Taxation Code, section 25120, subdivision (a), defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations."

tion.

On appeal, the taxpayer argued that section 25120, subdivision (a), does not provide for a separate, functional test for business income; that even if it exists and applies, the pension reversion did not satisfy the functional test; and that any attempted taxation by California of the pension reversion is unconstitutional. The Court of Appeal (Third Appellate District) agreed with the taxpayer that the pension reversion was not apportionable business income and reversed the trial court. In doing so, however, for the first time a California appellate court specifically confirmed in a published opinion the existence of the functional test of business income.[51] The court held that analyses under both the transactional and functional tests were required to classify pension reversion income as nonbusiness income.

In reaching this decision, the court examined the statutory language itself; the history and purpose of UDITPA; and interpretations of its provisions by the Franchise Tax Board, the State Board of Equalization, and as reflected in the case law from other states that have adopted similar definitions of business income. In doing so, the court noted that UDITPA's definition of business income was patterned after California's long-standing definition of unitary income,[52] and that the history of the uniform act became significant when California adopted that act. As a result, the court concluded, the State Board of Equalization was correct in *Appeal of Borden*, Cal. St. Bd. of Equal., Feb. 3, 1977,[53] in stating that "the continuity between the old and new law suggests that when the Legislature adopted the Uniform Act, it did not anticipate a change in the prior rule that income from assets which are an integral part of the taxpayer's business is subject to apportionment by formula, regardless of whether the income may arise from an occasional or extraordinary transaction." The court found particularly persuasive the analysis of the court in *Polaroid Corp*. v. *Offerman*, 349 N.C. 290 [507 S.E.2d 284] (1998), cert. den., 119 S. Ct. 1576 (1999), in concluding the plain language of the statute encompasses both the transactional and functional tests:

> [G]ramatically speaking, business income constitutes the subject of the sentence, which is thereafter defined by two independent clauses, each with its own verb and subsequent definitional language. In fact, the statute could grammatically be read as stating: 'Business income means income arising from transactions and activity in the regular course of the corporation's trade or business, and [business in-

[51] The court noted this fact, pointing out (at fn. 4) that because the parties in *Robert Half International, Inc*. v. *Franchise Tax Board*, 66 Cal. App. 4th 1020, 1024 (1998) (see discussion *supra*), had agreed the definition of business income set forth in section 25120, subdivision (a), contained both a transactional test and a functional test, the issue was not, in fact, litigated in that case.

[52] The court also found significant that the California Legislature has not seen fit to amend the definition of business income since adopting UDITPA, thus strongly suggesting that existing Board of Equalization decisions are in accord with legislative intent.

[53] In *Appeal of Borden*, the State Board of Equalization held that the taxable loss resulting on the sale of goodwill in Borden's liquidation of its California dairy and ice cream operations was business income/loss under the functional test subject to formula apportionment. In doing so, the SBE analyzed prior California law and regulations, expressly disagreeing with the rejection by Kansas and New Mexico courts of the functional test under their versions of UDITPA.

> come] includes income from tangible and intangible property ….' That is, [section 25120, subdivision (a)] does not contain a misplaced modifier, but rather utilizes a compound predicate to illustrate that 'business income' includes the definitions set forth in both the first and second clauses. [Citations.]" (*Polaroid, supra*, 349 N.C. at pp. 297-298 [507 S.E.2d at pp. 290-291]; accord, *Texaco-Cities Serv. Pipeline Co.* v. *McGaw* (1998) 182 Ill.2d 262 [695 N.E.2d 481]; *Laurel Pipe Line Company* v. *Com., Bd. of Fin. & Revenue* (1994) 537 Pa. 205 [642 A.2d 472].)

Applying the transactional test, the court determined that the pension reversion did not occur in the regular course of the taxpayer's business, that the removal of the pension funds was an extraordinary event, and that the reversion income was derived from the transaction rather than from the operations of the pension plan.

Turning then to the functional test, the court framed the inquiry as whether the gain from the pension reversion arose from property, the acquisition, management, and disposition of which constituted an integral part of the taxpayer's regular trade or business operations. The court concluded that it did not. Citing with approval the decision in *Robert Half International, Inc.* v. *Franchise Tax Board*, 66 Cal. App. 4th 1020, 1024-1025 (1998), the court held that the phrase "acquisition, management, and disposition of the property" must be read according to its plain meaning; i.e., in the conjunctive rather than the disjunctive. As a result, in the court's view, the assets of the trust were not integral to the taxpayer's business operations as required by the statute because the taxpayer did not own them. In this regard, the court noted that the "acquisition, management, and disposition" of the trust assets generated income for the plan beneficiaries rather than the taxpayer, and that while the taxpayer used the pension reversion for corporate purposes, it did not own the asset that generated the gain. As a result, the court found no evidence that the plan and trust were integral to the taxpayer's business of manufacturing and selling chemicals.

The California Supreme Court granted the Franchise Tax Board's petition for review in March, 2000. By virtue of that fact, the opinion of the Court of Appeal discussed in detail above was vacated. As required by court rules, briefing by the parties commenced shortly thereafter and is now completed.[54] It is anticipated that the court will set the case for oral hearing in the near fu-

[54] In arguing that the business income definition includes both a transactional and functional test, and that the pension reversion constitutes apportionable business income under both the transactional and functional tests, the Franchise Tax Board has framed the issues presented for the court to review as follows:

1. Does the business income definition (set forth in Revenue and Taxation Code section 25120, subdivision (a)) include (1) a transaction test and (2) a separate functional test for business income which can apply to income arising from an extraordinary event? If the definition includes a functional test, what is its scope?

2. Are surplus funds reverted to a company from its pension fund taxable as apportionable business income or taxable solely by the state in which the company is domiciled, when the pension plan and fund contribute to the operations of the multistate business?

    a) Does "property," as used in the business income definition, include only property to which the company has legal title or which it carries on its books of account, or does it include property

ture.

I. *Citicorp North America, Inc.* v. *Franchise Tax Board*[55] -- Cal. App. 4th – [-- Cal. Rptr. 2d --; 2000 Cal. App. LEXIS 773[56]] (1st App. Dist. No. A086925; Oct. 2, 2000)

The court in *Citicorp North America, Inc.* v. *Franchise Tax Board* had before it for review the propriety of Franchise Tax Board's allocation of California destination sales by the taxpayer's Citibank (South Dakota) affiliate, an issue not germane to discussion here, and characterization of the gain on sales of the following four properties as business income apportionable to California:

(1) The New York City corporate headquarters of the taxpayer and its wholly owned subsidiary, Citibank, N.A., which had constructed the building in 1961 to house corporate personnel. Citibank sold floors 17 through 39 in 1987 as part of a planned restructuring of its real estate holdings. Taxpayer affiliate personnel occupied all of the floors at the time of the sale and continued to occupy the remaining floors after the sale.

(2) A nine-story office building in New York City partially occupied by corporate personnel. Citibank purchased the building in 1907 to house corporate personnel. At the time of the sale, the taxpayer's personnel occupied three of the building's nine floors.

(3) Citicorp Center, a 59-story building in New York City built by Citibank in 1978 to house Citicorp and Citibank personnel. Some portions of Citicorp Center were leased in arm's length transactions to third parties such as attorneys and accounting firms doing business with the bank. The taxpayer sold floors 23 to 59 as part of the 1987 planned restructuring of its real estate holdings. At the time of the sale, the taxpayer and its affiliates occupied 47 percent (28 floors) of the building and 24 percent of the floors sold.

(4) A residence and land in Osaka, Japan. Citibank purchased this property in 1954 for the use of its corporate personnel while in Japan. A Japanese branch of Citibank sold the

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which the company controls, from which it derives an ongoing economic benefit, and to which it has a right of reversion?

b) Does "integral," as used in the business income definition, mean the same thing the California Supreme Court said it meant in the context of unitary taxation in general, in *Superior Oil* v. *Franchise Tax Board*, 60 Cal. 2d 406, 414 (1963); i.e., that it is based on "contributing activities," or is it limited to activities which are "necessary or essential"?

3. Is it proper to interpret the word "and," as used in section 25120 in the phrase "acquisition, management, and disposition," to include the disjunctive as well as conjunctive meaning of the word, if such an interpretation makes the business income definition consistent with the policy and objectives which led to its adoption.

[55] Authored by Fred Campbell-Craven.

[56] The Lexis pagination is subject to change pending release of the final published version of this opinion.

property.

Citibank financed the purchase of all of the properties. All costs and income from the properties was reported as business income, with the value of the four properties being treated as business property and the income from rentals as business income. The taxpayer included the original cost of the buildings in the denominator of its property factors reported to California, as well as the rental income and expenses associated with the management of each property.

Corporate Realty Services, a department of Citibank that manages premises occupied by the taxpayer and its affiliates, managed all of these properties and was responsible for leasing office space in the buildings during the years at issue, except that an outside agent was hired to manage Citicorp Center in the early 1980s.

The taxpayer reported the gain on the sale of these properties as nonbusiness income allocable to the respective situs of each property. The Franchise Tax Board determined that the sales gave rise to business income subject to apportionment. The trial court held in favor of the Franchise Tax Board in the taxpayer's suit for refund of corporate franchise taxes, and the taxpayer appealed.

On appeal, the taxpayer argued the gains were nonbusiness income because only a single transactional test of business income exists in California, and because the sales of corporate property were not made in the regular course of the taxpayer's banking business. Furthermore, the taxpayer argued, even if a separate functional test of business income exists, the gain was not business income because the acquisition, management, and sale of the properties was not an integral part of the taxpayer's business.

The court noted that the issue of whether separate transactional and functional tests of business income exist in California is presently pending before the California Supreme Court in *Hoechst Celanese Corp*. v. *Franchise Tax Board*, review granted Mar 1, 2000, S085091 (see discussion, *supra*). In this regard, the court observed that "[i]n the *Robert Half* case, the parties agreed that there were two tests of nonbusiness income and that the loss at issue would not qualify under the transactional test, so the court was not faced with resolution of those issues. (66 Cal.App.4th at p. 1024.)" *Citicorp North America*, 2000 Cal. App. LEXIS 773, at 48, fn. 23. Holding that "[t]he resolution of the issue of whether there are two tests is unnecessary in this case, because the questioned gain on sales produced business income under either the transactional or functional test," *id*., at 47-48, the court then proceeded to analyze the facts of the case under both the transactional and the functional tests of business income.

Turning first to the transactional test, the court held that the gain was properly characterized as business income because the transactions at issue occurred in the regular course of the taxpayer's business:

> The stipulated facts state that the sales of the properties were parts of a restructuring of Citicorp's real estate holdings. There is no evidence as to how often, or for what purpose Citicorp was restructuring its real estate holdings other than the fact that the restructuring resulted in sales of four corporate properties in one year.

> There is no evidence regarding the extent of its real estate holdings. This is not the same situation as the example of a manufacturer that makes a one-time sale of a warehouse. (See, e.g., Keesling & Warren, *California's Uniform Division of Income for Tax Purpose Act* (1967) 15 UCLA L.Rev. 156, 164 (hereafter Keesling).) Citicorp presented no evidence of the frequency, nature or extent of the real estate management activities of Corporate Realty Services. Citicorp argues that the sole function of its real estate management department was to manage property occupied by Citicorp affiliates. However, it references no evidence in the record as to the operations or function of the real estate department, other than the few stipulated facts in the record. The evidence was only that Citibank has a department devoted to management and leasing of real property. The evidence also supports a finding that Citicorp considered the income from the real estate properties to be business income prior to the sale. We conclude from the record in this case that Citicorp, with its separate department that acquires, manages, leases and ultimately sells corporate real property, produces business income when it engages in these transactions.

Id., at 53-54.

The court turned next to the functional test:

> We note that the functional test is not concerned with the frequency or extraordinary nature of a sale. Under that test, the gain is business income if the asset was disposed of used by the taxpayer in its regular trade or business operations. The functional test predates adoption of the UDITPA, and tracks the California definition of unitary income. (*Appeal of Borden, Inc.* (Feb. 3, 1977) [1971-1978 Transfer Binder] Cal. Tax Rptr. (CCH) ¶ 205-616; Keesling, *supra*, 15 UCLA L.Rev. at p. 164.) As illustrated by the commentators, "the sale by a shoe manufacturer of one of its factories is hardly a transaction 'in the regular course of the taxpayer's trade or business' (which is selling shoes, not selling factories), but perhaps the 'acquisition, management and disposition' of the factory was an integral part of the business of making and selling shoes." (Keesling, *supra*, 15 UCLA L.Rev. at p. 164.)
>
> There can be little argument that Citicorp managed its corporate headquarters, other office buildings, and the property in Japan as an integral part of its business. Although Citicorp repeatedly refers to itself as a bank, the stipulated facts indicate that Citibank is a bank, while Citicorp is a "worldwide financial services organization which serves the financial needs of individuals, businesses, governments and financial institutions throughout the United States and in many other countries."

Id., at 55-56.

Citing in support *Texaco-Cities Service Pipeline* v. *McGaw*, 695 N.E.2d 481 (Ill. 1998), *National Realty and Investment Co.* v. *Illinois Department of Revenue*, 494 N.E.2d 924, 932 (Ill. Ct. App.

1986), *Ross-Araco* v. *Commissioner, Board of Finance and Revenue,* 674 A.2d 691 (Pa. 1996), and especially *Polaroid Corp*. v. *Offerman,* 507 S.E.2d 284, 289 (N.C. 1998) (see discussion, *supra*), the court declined to follow cases relied upon by the taxpayer that it argued were well reasoned, were ignored by the trial court, and provided support for its position that a banking company selling its corporate office should never be assessed for business income on the gain. After first noting that the legislatures of the states in which courts had held only a transactional test exists "promptly amended their respective tax statutes to explicitly include the functional test within their definition of business income," *Citicorp North America*, 2000 Cal. App. LEXIS 773, at 57, quoting *Polaroid Corp*., 507 S.E.2d at 289, the court went on to state that, regardless, the record before it established that the income from the sales resulted from corporate activities satisfying either test in California. In a footnote to this discussion, the court also rejected the taxpayer's argument that the trial court had incorrectly found that FTB regulations (*i.e.*, Cal. Code Regs., tit. 18, §§ 25120, subd. (c)(2) (examples involving sale of a manufacturing plant), 25137-4-1 (income of banks and financial corporations)) did not compel business income treatment of the gains, distinguishing the regulations cited by the taxpayer on factual grounds. *Id*., at 56, fn. 25.

Finally, the court also rejected the taxpayer's argument, based on *Allied-Signal, Inc*. v. *Director, Div. of Taxation*, 504 U.S. 768, 787-789 (1992), and *ASARCO Inc.* v. *Idaho State Tax Comm'n*, 458 U.S. 307 (1982), that the inclusion of gains from the sale of the properties in the apportionment formula was unconstitutional because, given that the taxpayer's personnel did not occupy all portions of the buildings at the time of sale, the proceeds of the sale must have resulted from an investment, rather than an operational, purpose. After noting that the sole evidence in support produced by the taxpayer related to the percentage of occupancy of the properties by its personnel, the court reiterated the fact that the taxpayer's property management division rented out portions of the properties, that the taxpayer claimed the rental income as business income, and that no attempt appeared to have been made to separate out the various portions of the buildings that had been occupied or rented out when the taxpayer initially reported income from them as business income before the sales. The court concluded:

> The principles discussed in the cited cases impose no limits on the disposition of a corporate headquarters and other corporate properties by a wholly owned subsidiary of the unitary business. . . .
>
> The corporate office buildings in this case were not held as separate assets unrelated to the unitary business. Citicorp has not shown that the occupation and use of its office buildings had no connection to the California aspects of its multistate business. Citicorp included the costs and the income from all of the properties as business income prior to the sale. Inclusion of the gain from disposition of the properties is consistent with the stated constitutional limits on a state's taxing authority. The disposition of the real estate was stipulated to be a part of Citicorp's restructuring of its real estate holdings, a program that was not described further. Based upon the foregoing, the FTB's decision to categorize the capital gains as business income is reasonable, within constitutional limits, and is supported by the evidence.

Id., at 360-61.

IV. Hot Issues

A. The Functional Test: Alive and Well[57]

The majority of states analyzing the question accept the existence of a functional test of business income. In each of the four states in which a contrary line of authority has surfaced, the legislature acted to repudiate the courts' determination that the definition of business income does not include a functional test.[58] Nevertheless, the actual extent of the scope of the functional test of business income is question open to considerably more discussion. In attempting to apply the functional test, courts recently have been wrestling with the following questions:

(1) How should income from an extraordinary event be characterized?

(2) Should the definition of "property" in the context of the functional test include only property to which the taxpayer has legal title or that it carries on its books of account, or should it be read in a more expansive light?

(3) Does "integral," for purposes of the functional test, refer to contributing activities of a unitary trade or business, or those activities that are necessary and essential to it?

(4) Should "acquisition, management, and disposition" be read in the disjunctive or in the conjunctive?

These questions are addressed below.

B. Current Scope of the Functional Test

(1) Characterizing Income From an Extraordinary Event[59]

As discussed throughout this paper, the MTC and the majority of states have held that the UDITPA language and MTC definitions provide two alternative tests to determine whether income constitutes business income. The first is the "transactional test." Under this test, the relevant inquiry is whether the transaction or activity that gave rise to the income arose in the regular course of the taxpayer's trade or business. Under the second, or "functional test," income from

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[57] Authored by Fred Campbell-Craven.

[58] Iowa: *compare Phillips Petroleum Co*. v. *Iowa Dep't of Revenue & Fin*., 511 N.W.2d 608 (Iowa 1993) *with* Iowa Code, § 422.32; Kansas: *compare Western Natural Gas Co*. v. *McDonald*, 446 P.2d 781 (Kansas 1968) *with* K.S.A. §§ 79-3271(a) (providing an election to taxpayers); New Mexico: *compare McVean & Barlow* v. *New Mexico Bureau of Revenue*, 88 N.M. 521 (1975) *with* N.M. Stat. Ann. § 7-4-2, as amended in 1999 by H.B. 349; Tennessee: *compare Federated Stores Realty* v. *Huddleston*, 852 S.W.2d 206 (Tenn. 1992) *with* Tenn. Code Ann. § 67-4-804, *and Associated Partnership I, Inc.* v. *Huddleston* 889 S.W.2d 190, fn. 3 (Tenn. 1994).

[59] Authored by Jack Harper.

property is considered business income if the acquisition, management, and disposition of the property are "integral parts" of the taxpayer's regular trade or business operations, regardless of whether the income was derived from an occasional or extraordinary transaction.

Therefore, the primary purpose of the functional test inherently seems to be to classify income flowing from extraordinary circumstances as business income provided that the property at issue generating the income is integral to the taxpayer's trade or business. It would be difficult to find business income from extraordinary events using the transactional test because extraordinary transactions by nature normally do not arise in the regular course of business. Thus, for example, the Tennessee Supreme Court in 1993 found that the sale and liquidation of seven lines of business were of an extraordinary nature and, under the transactional test, could not be said to have occurred in the regular course of Union Carbide's trade or business (see discussion of *Union Carbide, supra*).

In reviewing recent cases, most have focused on the asset producing the income and not the extraordinary nature of how the income was derived. Using the functional test, most have found that the gain from the disposition of a capital asset is considered business income if the asset disposed of was utilized by the taxpayer in its regular trade or business operation. They have also found that the extraordinary nature or infrequency of the transaction is irrelevant.

The Illinois Court of Appeals in *Kroger* held that the gain from the sale of leaseholds constituted business income. Although Kroger argued that sale of its drug store operations was a restructuring that constituted an "extraordinary event," i.e., a restructuring outside its normal operations, the court did not comment on what relevance a finding of "extraordinary event" might have had on its decision that the gain was business income because it noted that in Kroger's SEC report, it used language that would lead one to believe that restructuring was a normal part of Kroger's operations.

Polaroid however, does seem to carve out an exception for extraordinary events involving liquidation cases. In footnote 6, the court stated, "[w]e do note however, that cases involving liquidation are in a category by themselves. Indeed, true liquidation cases are inapplicable to these situations because the asset and transaction at issue are not in furtherance of the unitary business, but rather a means of cessation." (See discussion of *Polaroid, supra*.)

And interestingly, in 1998, the California Court of Appeal held in *Robert Half* that a company's repurchase of a warrant was an extraordinary event constituting non-business income.

Boothe Financial Corporation (Boothe), a California domiciliary engaged in real estate development and computer sales and leasing, acquired the assets of an entity known as IDS Realty Trust (IDS) in a statutory merger. Pursuant to the merger terms, Boothe assumed the obligation to issue its own shares under a warrant held by a third party. Boothe's chairman and chief executive officer believed that the existence of the warrant, which gave its holder the right to purchase approximately 21 percent of the voting power of the corporation, had an unsettling effect on the market for Boothe's shares. Accordingly, Boothe paid the warrant holder $7.5 million to repurchase and cancel the warrant. Boothe deducted the entire $7.5 million payment as a nonbusiness loss on its California return. Upon audit, the Franchise Tax Board determined the pay-

ment was a business loss apportionable among the various states in which Boothe did business.

The court stated the issue in this matter was simply whether the loss Boothe incurred when it repurchased the warrant arose from tangible or intangible property, the acquisition, management, and disposition of which constituted an integral part of its regular trade or business operations. The court stated the answer was clearly no because Boothe's acquisition of the warrant was not an integral part of its regular trade or business. The court noted Boothe was not in the business of acquiring warrants and that the loss Boothe incurred to negate the possibility of the warrant being exercised was an extraordinary event. As a result, the court remanded the case for proceedings consistent with its opinion.

The FTB petitioned the court for a rehearing and, while the court denied the petition, it modified its opinion by adding a new footnote stating that no opinion was expressed "on whether income that arises when a taxpayer sells property that is used in its regular trade or business operations" should be business or non-business income, and that *no opinion was expressed concerning the relevancy or irrelevancy of the infrequent or extraordinary nature of a sale*. (*Robert Half Int'l*, 66 Cal. App. 4th at 1025, fn. 4.)

> **Comment**
> It would be unfortunate if the functional test merely serves as the alternative catch all for finding business income when the transactional test fails to do so. Should classifying business income be based solely on a finding that the income-producing asset is integral to a taxpayer's business operations? Or, should due consideration also be given to the circumstances that produced the income? If income from extraordinary events is to have any reasonable chance of constituting non-business income, the functional test must also take those circumstances into consideration. Some courts seem to be headed in the direction of considering those circumstances.

(2) Does "Property" Include Only Property to Which the Taxpayer Has Legal Title or That It Carries on Its Books of Account?[60]

In *Union Carbide Corporation* v. *Offerman*, 351 N.C. 310 [526 S.E.2d 167] (2000) (see discussion, *supra*), the North Carolina Supreme Court held that reverted surplus pension funds were not apportionable business income under the functional test. The court reasoned that the taxpayer held a contingent property right in the pension plan that was neither essential nor integral to its business, and that the pension plan's assets were not used to generate income in the taxpayer's regular business operations as required under the plain language of the functional test:

> In analyzing the plain language of N.C.G.S. § 105-130.4(a)(1), this Court in *Polaroid II* [*Polaroid Corp*. v. *Offerman*, 349 N.C. 290 [507 S.E.2d 284] (1998)] first noted "the phrase 'acquisition, management, and/or disposition' contemplates the indicia of owning corporate property.'" *Polaroid II*, 349 N.C. at 301, 507 S.E.2d at 292. The pension plan in the instant case was not Union Carbide's

[60] Authored by Fred Campbell-Craven.

> property. Union Carbide was the plan's sponsor, not its owner. Therefore, Union Carbide did not acquire, manage, and/or dispose of any corporate property. Union Carbide held only a contingent property right in the excess funds in the event of a plan termination.
>
> Additionally, in *Polaroid II*, we defined "integral" as "'essential to completeness.'" *Id*. (quoting *Merriam-Webster's Collegiate Dictionary* 607 (10th ed. 1993 [sic])). In the instant case, the contingent property right was not integral or essential to Union Carbide's business of making and selling alloys and chemicals.
>
> Moreover, the phrase "regular trade or business operations" refers to business operations done in a recurring manner, or at fixed or uniform intervals. *See Merriam-Webster's Collegiate Dictionary* 985 (10th ed. 1999). In the instant case, the assets of the pension plan were not used to generate income in the regular business operations. The assets were not working capital. The assets were not used as collateral in borrowing. The assets were not actively traded. Finally, the assets were not relied upon to purchase equipment or support research and development. Thus, the reversion of excess funds by Union Carbide, a one-time occurrence, not a recurring event, was not part of Union Carbide's "regular trade or business operations."
>
> In sum, the assets were not *essential* to Union Carbide's regular trade or business operations. The assets were merely surplus investment assets which were not needed to meet the obligations of the pension plan. Thus, Union Carbide's contingent property right in the excess pension plan funds does not meet the functional test of business income. The plan funds were not integral to Union Carbide's regular trade or business operations of making and selling alloys, chemicals, industrial gases, and plastics. The plan funds, which produced the income at issue, functioned as an investment for the benefit of Union Carbide employees.

(*Union Carbide*, 351 N.C. at 315-316.)

In *Hoechst Celanese Corp*. v. *Franchise Tax Board* (California Court of Appeal, Third Appellate District, No. C030702, Dec. 3, 1999; opinion since vacated by operation of law on acceptance of case by California Supreme Court), the court followed North Carolina's lead in holding that gain from the pension reversion at issue in the case did not arise from property, the "acquisition, management, and disposition" of which constituted an integral part of the taxpayer's regular trade or business operations. As a result, the court found that the gain was not apportionable business income under the functional test. In reaching this conclusion, the court pointed out that the assets of the trust were not integral to the taxpayer's business operations as required by the statute because the taxpayer "did not hold title to the investments in the [t]rust." After first rejecting FTB's position that "acquisition, management, and disposition" should be read in the disjunctive rather than the conjunctive "to carry out 'the Legislature's obvious intent as gleaned from the context,'" the court turned to the North Carolina Supreme Court's opinion in *Polaroid Corp*. v. *Offerman*, 349 N.C. 290 [507 S.E.2d 284] (1998), cert. den., 119 S.Ct. 1576 (1999) (emphasis in original):

> The North Carolina Supreme Court provided a more complete analysis of the language of that state's identical statute in *Polaroid*. "First, we note that the phrase 'acquisition, management, and/or disposition' contemplates the indicia of owning corporate property. [Citation.] Moreover, Webster's Dictionary defines 'integral' as meaning 'essential to completeness.' Merriam-Webster's Collegiate Dictionary 607 (10th ed. 1993). Therefore, reading the second clause as a whole, business income includes income obtained from acquiring, managing, and/or disposing of property which is essential to the corporation's business operations." (349 N.C. at p. 301 [507 S.E.2d at pp. 292-293].)
>
> Here, Celanese did not hold title to the investments in the Trust. Celanese's role was limited to appointing members of the investment committee who, in turn, appointed the fund managers. A trustee held the assets of the Trust, and the individual employees and retirees who participated in the Plan were its beneficiaries. At no time did the assets of the Plan or Trust appear on Celanese balance sheets; nor were the earnings of the Trust reported on the corporation's books of account. Although Celanese used the $388.8 million pension reversion for corporate purposes, that is, in a stock redemption program to reduce the number of outstanding shares, the corporation did not own the asset that generated the gain. We conclude indicia of corporate ownership are simply not present in this record.
>
> There is also no evidence the Plan and Trust were integral to Celanese's business of manufacturing and selling chemicals. The parties acknowledge that Celanese maintained the Plan as an inducement to retain its current employees and to attract other qualified employees. However, the acquisition, management, and disposition of the trust assets were not part of Celanese's regular trade or *business* operations of manufacturing and selling chemicals: Celanese did not hold title to the assets, and in the regular course of its business, the acquisition, management, and disposition of the trust assets did not generate income for Celanese's business, but for the Plan beneficiaries. Thus, they were not part of its business operations. The fact that the termination of the [plan and trust] resulted in a pension reversion to Celanese did not transform the trust assets into an integral part of its business operations.
>
> Accordingly, we conclude as a matter of law that the $388.8 million pension reversion was not business income for purposes of section 25120, subdivision (a).

The conclusion seemingly to be reached in reading these cases together regarding property—i.e., ownership of property for purposes of analysis under the functional test of business income requires that the taxpayer actually hold title to the property—is subject to question. Given the fact that the California Supreme Court has granted review in *Hoechst Celanese*, query:

- Are the conclusions reached in *Union Carbide*, or at least in *Hoechst Celanese*, equating ownership with holding title consistent with traditional concepts of property law, under which ownership of property has been equated to a bundle of rights and privileges, as

well as of obligations? Furthermore, does property cease to be such simply because limitations and restrictions have been placed on its use? For example, intangible property is defined as a "right" and can include choses in action and other items that do not have a readily ascertainable value, or that would not be found in a taxpayer's books of account.

- Is the *Union Carbide* court's characterization of a taxpayer's interest in a pension fund surplus as a "contingent property right" consistent with reality, contract law, and/or the United States Supreme Court's recent clear pronouncement in *Hughes Aircraft Co*. v. *Jacobson*, 525 U.S. 432, 440-441 (1999), that a company with a surplus in its defined benefit pension plan can reap the surplus or reduce its contributions, and that employees and retirees have an interest only in their accrued benefits rather than any interest in the surplus itself?

- Is defining "property" to mean something to which the taxpayer must formally hold title in conflict with the understanding of "property" as it is used elsewhere in UDITPA, as well as UDITPA's concentration on the use of property in the context of a taxpayer's regular trade or business rather than on whether particular formal indicia of ownership are present? For example, in determining a taxpayer's property factor, "property" is defined as including real and tangible personal property owned *or rented and used* by the taxpayer.

- Is the notion that the absence of formal legal title to assets defeats a business income finding consistent with constitutional principles and sound public policy? Should a finding of business income properly be defeatable by taking the expedient of contributing a portion of a corporation's assets to, for example, an entity such as a revocable trust?

(3) Does "Integral" Refer to "Contributing Activities" or "Necessary and Essential"?[61]

Does "integral" mean "essential to"? Directly related to? Operational? Furthering operations? Closely related to?

Early California (and later in* Borden*): "Essential," "Directly Contributes or Related To"(?)

(1) In *Marcus Lesoine*, the California State Board of Equalization observed that interest collected on conditional sales contracts constituted an "integral" asset of the taxpayer's business: "[T]he acquisition, management and *liquidation* of the intangibles constitute integral parts of the corporation's business operations." (Emphasis added.)

(2) In *Houghton-Mifflin*, the SBE observed that the copyrights which generated the royalties were integral parts of the taxpayer's book publishing business, and but for them, the intangibles would have no value.

[61] Authored by Deborah Mayer.

(3) In *IBM,* royalties from patents constituted integral parts of the taxpayer's business machines and equipment business because the patents on these assets were developed for use in IBM's regular business operations.

(4) In *Holly Sugar Co.,* since the taxpayer acquired the stock of a new corporation to enhance its business when it sold the stock, the stock and the sale were integral parts of the taxpayer's business and the taxpayer had to include it in its allocation formula.

(5) In *Appeal of American Snuff,* the SBE seemed to equate "integral parts of taxpayer's regular trade or business operations" with "directly related to the activities of the unitary business." The loans increased employee efficiency, thereby contributing to the operations of the unitary business.

(6) In *Appeal of Borden,* 22 Cal. Tax Cases 21, 24 [1971-1978 Transfer Binder] Cal. Tax Reports (CCH) ¶ 205-616, p. 14,897-58 (Cal. St. Bd. Equal., Feb. 3, 1977) (loss on sale of goodwill in a liquidation of a dairy and ice cream operations integral part of business),[62] the SBE noted that "goodwill makes possible the profitable operation of a business . . . [and] goodwill is so *essential* to the viable conduct of a business that it has been held to be *inseparable* from the business as a whole." (Emphasis added.) The dairy had been acquired in furtherance of its business operations, and even though the taxpayer did not take any deductions for the goodwill, thereby not reducing its unitary business income "the loss on the sale of the goodwill may appropriately be attributed to appellant's business as a whole."

U.S. Supreme Court Implements the "California" Way of Looking at "Integral"?

(1) In *Mobil,* the Court stated that the "linchpin of apportionability is the unitary-business principle" where dividends from wholly owned domestic subsidiaries were apportionable. *Container* refers to "operational" versus "investment" capital transactions.

(2) In *ASARCO,* since ASARCO was not unitary with the dividend, interest, and capital gains ("intangibles") paying subsidiaries, the intangibles were not "integral parts of the taxpayer's regular trade or business," i.e., were not directly related to its mining and smelting operations.

(3) In *Woolworth,* the mere fact that Woolworth could—but did not—control the foreign majority owned subsidiaries that paid dividends, foreign currency transactions and gross ups of those intangibles were not "integral parts of the taxpayer's retail business" and were not business income apportionable to New Mexico.

[62] As explained in the *Appeal of W. J. Voit Rubber Corp*., decided May 12, 1964: The underlying principle in the earlier SBE cases is that any income from assets which are integral parts of the unitary business is unitary income. It is appropriate that all returns from property developed or acquired and maintained through the resources of and in furtherance of the business should be attributed to the business as a whole. And, with particular reference to assets which have been depreciated or amortized in reduction of unitary income, it is appropriate that gains upon the sale of those assets should be added to the unitary income.

State Courts Vary

(1) In *District of Columbia.* v. *Pierce Associates,* proceeds from an insurance recovery on a flooded manufacturing plant were business income because the manufacturing plant had been an integral part of the taxpayer's business because it **"**furthered**"** the taxpayer's business of furnishing and installing mechanical systems.

(2) In *Ross-Araco Corp. v. Commonwealth, Bd. of Fin. & Revenue* 544 Pa. 74 [674 A.2d 691] (1996), the gain on the sale of a parcel which never *contributed to* the taxpayer's contracting business was held not an "integral" part of the taxpayer's business. The taxpayer was a contractor in the construction business who did business in Pennsylvania and elsewhere. The contractor purchased a 24.5 acre parcel of land. Part of the parcel included a fenced three-acre portion of the property with a building which the taxpayer used to store equipment and materials used in its construction business. That three-acre parcel was not involved in the case. The case only concerned the sale of the remaining 21.5 acres, 28 years after its purchase, for a substantial profit. 674 A.2d, at 692. The 21.5-acre parcel, which was heavily wooded, remained unimproved during its ownership by Ross-Araco. There was no evidence to suggest that the parcel had ever contributed to the taxpayer's business. *Ross-Araco* properly concluded that the proceeds were not business income.

(3) In *Texaco-Cities Pipeline Company* v. *Illinois Department Of Revenue*, 182 Ill. 2d 262 [695 N.E.2d 481] (1998), the Illinois Supreme Court, interpreting those words, first quoted Webster's Third New International Dictionary and concluded that an income producing asset is integral if it *closely relates* to the taxpayer's trade or whole process of operating the business; if both the asset and its sale are "essential to Taxpayer's business operations"; and finally concluded that if the asset was "used" in the trade or business, its sale constitutes business income. "The use of a capital asset in the taxpayer's regular trade or business indisputably renders that asset an integral part of taxpayer's regular business operation." 182 Ill. 2d 262, 272 [695 N.E.2d 481, 486].

(4) In *Firstar Corporation* v. *Commissioner of Revenue*, 575 N.W.2d 835 (Minn. 1998), involving a "once-in-a-lifetime" sale of executive headquarters in Milwaukee, Wisconsin, resulting in a gain of $195 million that was determined to be nonbusiness income, the asset was held not to be one integral to the taxpayer's bank holding company business in Minnesota because it occurred completely outside the scope of that business.

The sale of the Wisconsin property was irregular in its nature as well as its scope. In addition to the distinctions set forth above regarding the irregular nature of this transaction, the entire appreciation of the value of the Wisconsin property, the decision to sell, and the execution of the sale agreement all occurred before Firstar acquired its first bank holding company in Minnesota. These facts strongly support that the acquisition, management, and disposition of the Wisconsin property was not an integral part of Firstar's ongoing business in Minnesota.

(5) In *Hercules Inc.* v. *Commissioner of Revenue,* 575 N.W.2d 111 (1998), the gain on the sale of a joint venture interest in a polypropylene manufacturing and distribution joint venture

was held not integral to the taxpayer's business operations where Hercules carried the asset on its books as an investment and only sold its interest in response to a hostile takeover threat, and the court could not ascertain that Hercules "wanted or needed the proceeds" to provide operating funds.

(6) In *Union Carbide* v. *Offerman* 351 N.C. 310 [526 S.E.2d 167] (2000) pension reversion funds were held to not constitute "integral parts of a company's regular trade or business operations of producing alloys and chemicals." Attracting more qualified employees by offering the pension plan was held *not essential* to the corporation's regular trade or business operations. Moreover, whether or not the funds were classified as "necessary business expenses," they were not used "in the regular course of the corporation's trade or business" and were not "integral" to "the corporation's regular trade or business operations" in North Carolina. Therefore, Union Carbide did not have to pay income tax on the reverted funds in North Carolina. 526 S.E.2d, at 168.

If, assuming *arguendo,* the pension plan was Union Carbide's property, then the acquisition, management, and/or disposition of the pension plan still did not constitute an integral part of Union Carbide's regular trade or business operations. While the plan may have assisted Union Carbide in attracting more qualified employees, the pension plan itself is not essential to Union Carbide's regular trade or business operations of producing alloys and chemicals. Moreover, while there exists a possibility that some of the reverted funds consisted of principle which had been deducted as business expenses by Union Carbide, rather than merely gains on investment, the court deemed itself limited to the matters of record and unable to apportion any unknown amounts. Accordingly, the court held that under the plain language of the functional test of North Carolina General Statutes section 105-130.4(a)(1), the reversion of excess pension plan funds was not business income to Union Carbide.

(4) Should "Acquisition, Management, and Disposition" Be Read in the Disjunctive or the Conjunctive?[63]

The functional test in California is set forth in the last 26 words of Revenue and Taxation Code section 25120(a). Under the functional test as set forth in UDITPA, income is business income if it is

> income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

The courts of several states have read the language of the test to be *conjunctive* -- that is, that each of the "acquisition, management, and disposition" of property must constitute an "integral part" of the taxpayer's "regular trade or business operations." *General Care Corp*. v. *Commissioner of Revenue*, 705 S.W.2d 642, 646 (Tenn. 1986:[64]

[63] Authored by Glenn Smith.

[64] *See also Phillips Petroleum Co*. v. *Iowa Department of Revenue*, 511 N.W.2d 608, 610 (Iowa 1993); *In re Appeal of Chief Industries, Inc*., 875 P.2d 278, 282 (Kan. 1994). *But see* discussion, *infra*, regarding later actions of state

> We find the Commissioner's position that the 'disposition' of property need not be within the scope of the taxpayer's regular business operations in order to give rise to business income contrary to the plain language of the statute. The drafters' use of the conjunction 'and' clearly indicates that the disposition, as well as the acquisition and management of property must be an integral part of the taxpayer's regular trade or business operations in order to produce business earnings. This Court will presume that every word used in a statute was intended by the General Assembly to convey meaning and purpose."

In a recent Alabama case, *Ex Parte Uniroyal Tire Company (Re: Uniroyal Tire Company* v. *State Department of Revenue)*, -- So.2d --, 2000 Ala. LEXIS 338 (2000) (see discussion, *supra*), the Alabama Supreme Court reasoned to the same conclusion:

> We recognize the fact that "the legislature's use of the disjunctive conjunction 'or,' as opposed to the conjunctive conjunction 'and,' is not conclusive with respect to the legislature's intent," and that "this Court is at liberty in ascertaining the intent of the legislature to construe the disjunctive conjunction 'or' and the conjunctive conjunction 'and' interchangeably." *Ex parte Jordan*, 592 So. 2d 579, 581 (Ala. 1992) (emphasis added). However, "while there may be circumstances which call for an interpretation of the words 'and' and 'or,' ordinarily these words are not interchangeable." 1A Norman J. Singer, Sutherland Statutory Construction § 21.14 (5th ed. 1993) (emphasis added). "The literal meaning of these terms should be followed unless it renders the statute inoperable or the meaning becomes questionable." Id. at 26 (Supp. 2000) (emphasis added). See also *Kearney v. Ahmann*, 264 N.W.2d 768, 769 (Iowa 1978) ("When the word 'or' is used it is presumed to be disjunctive unless a contrary legislative intent appears."); *Boron Oil Co. v. Cathedral Found., Inc.*, 434 S.W.2d 640, 641 (Ky. Ct. App. 1968) (court should not interchange "or" with "and," unless it is "obvious that the intent of the legislature would be thwarted if the change were not made"). To substitute by judicial construction the word "or" for the word "and" would significantly impact the scope of this statute.

Id., -- So. 2d at --.

The Alabama Supreme Court quoted from a commentator to the same effect:

> The literal language of the second clause of the definition provides that gain from the sale of property will be business income only if the property's 'disposition' is an integral part of the taxpayer's business. The word preceding the word 'disposition' is 'and'—not or—and it seems clear as a matter of statutory interpretation that the mere use of the property in the business is not enough to convert gain from its sale into business income. Property that is not regularly disposed of, but rather is held indefinitely, does not fit within the definition. The careful reading

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legislatures.

> of the statute by the Tennessee [Supreme Court] in *General Care* is persuasive."
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> P. Faber, When Does the Sale of Corporate Assets Produce Business Income for State Corporate Franchise Tax Purposes? The Tax Executive 179, 187 (May-June 1995). We agree with these comments . . . .

Id., -- So. 2d at --.

In California, the Court of Appeal in *Robert Half International, Inc.* v. *Franchise Tax Board*, 66 Cal. App. 4th 1020 (1st App. Dist. 1998) (see discussion, *supra*), implicitly found the functional test to be conjunctive when it found that loss from the taxpayer's payment to cancel a warrant was nonbusiness income because *acquisition* of the warrant had not been an integral part of the taxpayer's "regular . . . business operations." This point was noted by the Third Appellate District in *Hoechst Celanese Corp.* v. *Franchise Tax Board*, 76 Cal. App. 4th 914, 929 (3rd App. Dist. 2000) (see discussion, *supra*).[65]

In *Texaco-Cities Service Pipeline Co.* v. *McGaw*, 695 N.E.2d 481, 485 (Ill. 1998), the Supreme Court of Illinois may have attempted to broaden the scope of the functional test by reading it "as a whole," instead of limiting itself to a parsing of the statutory language:

> Turning to the meaning of the second clause, we note that the term "integral" means "of, relating to, or serving to form a whole: essential to completeness: organically joined or linked." Webster's Third New International Dictionary 1173 (1993). The term "operations" is defined as "b: the whole process of planning for and operating a business or other organized unit . . . c: a phase of a business or of business activity." Webster's Third New International Dictionary 1581 (1993). Placed in their statutory context, these terms indicate that the acquisition, management and disposition of the income-producing property must closely relate to the taxpayer's regular trade or whole process of operating its business. Further, in our view, the words "acquisition, management, and disposition" suggest elements typically associated with the "keeping" of corporate property, or, as observed in *Kroger*, the "conditions of ownership" of corporate property. 284 Ill. App. 3d at 479. *Thus, interpreting the second clause as a whole, the sale of property will constitute business income if the property and sale are essential to the taxpayer's business operations*. [Emphasis added.]

Several states have altered the UDITPA language in their statutes. In North Carolina, the statutory phrase is "and/or" rather than "and," which mandates a disjunctive test. N.C. Gen. Stat. § 105-130.4(a)(1).

In 1996, the Kansas legislature amended (in Kan. Laws 1996, ch. 264, § 1) its version of the definition of "business income," in K.S.A. 79-3271, to provide (functional test in italics, changes underscored):

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[65] Because *Hoechst Celanese* has been accepted for review by the California Supreme Court, the Court of Appeal decision is suspended pending that review and may not be cited as precedent.

(a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business *and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations*, except that for taxable years commencing after December 31, 1995, a taxpayer may elect that all income derived from the acquisition, management, use or disposition of tangible or intangible property constitutes business income. The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations.

(The underscored language is not contained in California Revenue and Taxation Code section 25120.)

And as summarized by the Alabama Supreme Court in *Uniroyal Tire Company*,

> two [other] state legislatures amended their definition of "business income" by striking out the word "and" [in the functional test] and substituting the word "or." N.M. Stat. Ann. 1978, § 7-4-2 (responding to *McVean & Barlow, Inc. v. New Mexico Bureau of Revenue*, 88 N.M. 521, 543 P.2d 489, supra; Tenn. Code Ann., § 67-4-2004(1) (responding to *General Care Corp. v. Olsen*, 705 S.W.2d 642 (Tenn. 1986), and its progeny). Similarly, in response *to Phillips Petroleum Co. v. Iowa Dep't of Revenue & Fin.*, 511 N.W.2d 608 (Iowa 1993), the Iowa legislature amended its statute to read as follows (Iowa Code § 422.32.2):
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> > "'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business; or income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations; or gain or loss resulting from the sale, exchange, or other disposition of real property or of tangible or intangible personal property, if the property while owned by the taxpayer was operationally related to the taxpayer's trade or business carried on in Iowa or operationally related to sources within Iowa, or the property was operationally related to sources outside this state and to the taxpayer's trade or business carried on in Iowa; or gain or loss resulting from the sale, exchange, or other disposition of stock in another corporation if the activities of the other corporation were operationally related to the taxpayer's trade or business carried on in Iowa while the stock was owned by the taxpayer."

-- So. 2d at --.

TABLE OF JURISDICTIONS ADOPTING UDITPA

Jurisdiction	Laws	Effective Date	Statutory Citation
Alabama	1967, p. 982	9-6-1967	Code 1975 § 40-27. Art. IV
Alaska	1959, c.175	1-1-1960	AS 43.19.010, art. IV
Arizona	1983, c.287 §5	12-31-1983	A.R.S. §§ 43-1131 to 43-1150
Arkansas	1961, Act No. 413	1-1-1961	A.C.A. §§ 26-51-701 to 26-51-723
California	Stats. 1966 c.2	7-1-1967	Cal. Rev. & Taxation C. §§ 25120 to 25141
Colorado	1968, p.175		C.R.S.A. §§ 24-60-1301 Art. IV
District of Columbia	1997 D.C. Law 11-254	4-9-1997	D.C. 1981 § 47-441 art. IV
Hawaii	1967, c. 33		HRS 235-21 to 235-39
Idaho	1959, c. 299		I.C. § 63-3701, art. IV
Kansas	1963, c. 485	1-1-1963	K.S.A. 79-3271 to 79-3293
Kentucky	1950, c. 73		K.R.S. 141.120
Maine	1969, c. 154	10-1-1969	36 M.R.S.A. §§ 5210, 5211
Michigan	1969, No. 343	7-1-1970	M.C.L.A. § 205.581, art. IV
Missouri	1967, p. 102		V.A.M.S. § 32.200, art. IV
Montana	1969, c. 17		M.C.A 15-31-301 to 15-31-313
Nebraska	1967, c. 485		R.R.S. 1943, § 77-2901, art. IV
New Mexico	1965, c. 203	1-1-1966	N.M.S.A., 1978, §§ 7-4-1 to 7-4-21
North Dakota	1965, c. 419	1-1-1965	N.D.C.C. 57-38.1-01 to 57-38.1-21
Oregon	1965, c. 152		O.R.S. 314.605 to 314.675
South Dakota	1976, c. 101		S.D.C.L. 10-54-1, art. IV.
Texas	1967, c. 566	6-13-1967	V.T.C.A., Tax Code § 141.001, art. IV
Utah	1958, c. 1574	1-1-1967	U.C.A. 1953, 59-7-301 to 59-7-321
Washington	1967, c. 125		R.C.W.A. 82.56.010, art. IV

Compiled by Deborah Mayer

Source: West's Uniform LawsAnnotated, Vol. 7A, Part I.

State*	Functional & Transactional	Transactional Only	Cases/Statutory Sections and Some Sample Instructions from Selected States
Alabama		**Yes***	*Uniroyal v. Dept. of Revenue*, 1999 WL 339304 (Ala.Civ.App. 1999) *(on appeal* Case No. 1981928), *rev'd and remanded* 2000 WL 1074041 (August 4, 2000). * Supreme Court held statute only contains one test and Alabama's regulation conflicted with the statute. Ala. Code § 40-27-1 (1975) "1. As used in this article, unless the context otherwise requires: (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Ala. Adm. Code "[Reg. 810-3-31-.02(1)(a)4.(ii)] As a general rule, gain ... from the sale, exchange or other disposition of real or tangible or intangible personal property constitutes business income if the property while owned by the taxpayer was used to produce business income." Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment
Alaska	**Yes**		*State, Dept. of Revenue v. OSG Bulk Ships, Inc*., 961 P.2d 399 (Alaska, Feb 20, 1998) (NO. S-7498) *Earth Resources Co. of Alaska v. State, Dept. of Revenue*, 665 P.2d 960 (Alaska, Feb. 10, 1983) (NO. 5762, 2614, 815) . Alaska Statutes § 43.19.010 "1. As used in this Article, unless the context otherwise requires: (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Regulations: 15 Alaska Administrative Code ("AAC") §19.011; 15 AAC §19.031 Instructions Alaska Corporation Net Income Tax Return forms ALLOCATION AND APPORTIONMENT OF INCOME A taxpayer with business income attributable to sources within and outside Alaska must apportion such income. To calculate the apportionment percentage, use Schedule I - Apportionment Factor. Apportionment refers to the division of business income among states by the use of an apportionment formula. Location refers to the assignment of non-business income to a particular state. Alaska applies both the transactional and functional tests of business income. Income resulting from transactions or activities that are within the regular course of the taxpayer's trade or business are business income. Income from tangible or intangible property is business income, if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business. Income meeting either the functional or the transactional test is business income. Income from transactions or activity that is unusual or infrequent is not non-business income solely because of the unusual or infrequent nature of the income, activity, or transaction. Non-business income is all income other than business income. Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment
Arizona	**Yes**		*General Motors Corp. v. Arizona Dept. of Revenue*, 189 Ariz. 86, 938 P.2d 481, 230 Ariz. Adv. Rep. 48, Pens. Plan Guide (CCH) P 23931K (Ariz. App. Div. 1, Nov 26, 1996) (NO. 1 CA-TX 95-0015) Arizona Rev. Statutes § 43-1131(B)(1) As used in this article, unless the context otherwise requires: 1. "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations.

- Compiled by Deborah H. Mayer.

State*	Functional & Transactional	Transactional Only	Cases/Statutory Sections and Some Sample Instructions from Selected States
Arkansas	**Yes**		*St. Louis Southwestern Railway Co. v. Ragland*, 304 Ark 1, 800SW2d 410 (1990); *Collins v. Skelton,* 256 Ark. 955, 512 SW2d 542 (1974)*; Pledger v. Getty Oil Exploration Company,* 309 Ark. 257, 831 SW2d 121 (1992)*; Pledger v. ITW*, 306 Ark. 134, 812 SW2d 101 (1991); *Qualls v. Montgomery Ward & Co*., 585 S.W.2d 18 (Ark. 1979) Ark. Code Ann. § 26-51-701(a) ". . . (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. . . Ark. Corp. Inc. Tax Reg. 2.26-51-701 "Business income" means income arising from transactions and activities in the regular course of a taxpayer's trade or business. Business income also includes income from tangible and intangible property if the acquisition, management and disposition (sale, exchange, etc.) of such property is an integral part of the taxpayer's regular trade or business operations. "Nonbusiness income means all income other than business income. Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment
California	**Yes**		*Citicorp North America, Inc.* v. *Franchise Tax Board*, -- Cal. App. 4th – [-- Cal. Rptr. 2d --; 2000 Cal. App. LEXIS 773[1]] (1st App. Dist. No. A086925; Oct. 2, 2000) *Hoechst Celanese Corp. v. FTB*, 76 Cal. App. 4th 914 [90 Cal. Rptr.2d 768] (3d App. Dist. 1999); *Robert Half International v. FTB*, 66 Cal. App. 4th 1020 [78 Cal. Rptr. 2d 453] (1998) *Times Mirror Co. v. FTB*, 102 Cal. App. 3d 872, 162 Cal. Rptr. 630 (2d Dist. 1980) *Appeal of Borden*, 22 Cal. Tax Cases 21 (SBE 1977) Cal. Stat. Ann. § 25120 "As used in Section 25120 to 25139, inclusive, (which shall hereafter be referred to as "this act") unless the context otherwise requires: (a) 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." 18 Cal. Code Regs § 25120(a) FTB Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment
Colorado	**Yes**		*Lonestar Steel Co. v. Dolan*, 668 P.2d 916 (Colo. 1983) *Atlantic Richfield Co. v. State of Colorado*, 601 P2d 628, 631-632 (Colo. 1979). Colorado Rev. Statutes Ann. § 24-60-1301: "1. As used in this Article, unless the context otherwise requires: (a) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment
Connecticut	**N/A**	**N/A**	Full apportionment within Constitutional Limitations See, Connecticut General Statutes Ch. 208, Title 12, Sec.12-218
Delaware	**N/A**	**N/A**	Full apportionment within Constitutional Limitations Del. Code Ann.30 § 1902(a) and 1903(a) 1999 Form 1100-I – Corporate Income Tax Instructions state that Delaware has not adopted UDITPA.

State*	Functional & Transactional	Transactional Only	Cases/Statutory Sections and Some Sample Instructions from Selected States
District of Columbia	**Yes**		*District of Columbia v. Pierce Associates, Inc.*, 468 A2d 1129 at 1131-1132 (DC App. 1983): [1][2] We are now persuaded that the District's interpretation of the statute is correct. The second clause of UDITPA's business income definition provides an alternative, "functional" test. We conclude the District reasonably may decide that "the acquisition, management, and disposition of [ ] property constitute[s] an integral part[ ] of the taxpayer's regular trade or business," D.C.Code § 47-441 Art. IV (1)(a), if--however sporadically--it arises out of normal business operations. [FN3] FN3. The Supreme Court has defined the outer limits of income that the state may apportion and tax consistently with the Due Process Clause of the Constitution, as "corporate income that is 'reasonably related to the activities conducted within the taxing state.' In order to exclude certain income from the apportionment formula [on constitutional grounds], the company must prove that 'the income was earned in the course of activities unrelated to [taxpayer's business in the state].' The court looks to the 'underlying economic realities of a unitary business,' and the income must derive from 'unrelated business activity' which constitutes a 'discrete business enterprise.' " (Citations omitted). DC Code § 47-441 Art. IV (1)(a) Informally Adopted in part MTC Uniformity Recommendations as of 1987 on General Allocation and Apportionment
Florida	**N/A**	**N/A**	*See,* Florida Statutes § 220.03(1)(r) defining nonbusiness income (r) "Nonbusiness income" means rents and royalties from real or tangible personal property, capital gains, interest, dividends, and patent and copyright royalties, to the extent that they do not arise from transactions and activities in the regular course of the taxpayer's trade or business. The term "nonbusiness income" does not include income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations, or any amounts which could be included in apportionable income without violating the due process clause of the United States Constitution. For purposes of this definition, "income" means gross receipts less all expenses directly or indirectly attributable thereto. Functionally related dividends are presumed to be business income. (9/84) Florida Administrative Code Ann. Rule 12C-1.016 See, Florida Technical Assistance Advisement 97(C)1-007, 11/07/1997 Informally Adopted In Part MTC Uniformity Recommendations as of 1987 on General Allocation and Apportionment
Georgia	**N/A**	**N/A**	Full apportionment within Constitutional Limitations Georgia Code Ann. 48-7-31 Although the Statute refers to the term "business income" it is not defined within the statute, rather the statute states: "(a) The tax imposed by this chapter shall apply to the entire net income, as defined in this article, received by every foreign or domestic corporation owning property or doing business within this state. Ga. Comp. R. & Regs. 560-7-7-.03
Hawaii	**Yes**		Hawaii Rev. Statutes §235-21: "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. Hawaii Administrative Rules §§18-235-21-02, -03, & -04. Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment
Idaho	**Yes**		*ASARCO, Inc. v. Idaho St. Tax Comm*, 445 U.S. 939, 100 S. Ct. 1333 (1980), reinstated on remand, 102 Idaho 38, 624 P.2d 946 (1981), rev'd on constitutional grounds, 458 U. 307, 102 S. Ct. 3103 (1982), reh. den., 459 U.S. 961, 103 S. Ct. 275 (1982). *TTX v. Idaho State Tax Commission*, 915 P2d 713 (Idaho, 1996) Idaho Code §63-3027 and 3701; (a) As used in this section, unless the context otherwise requires: (1) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from the acquisition, management, or disposition of tangible and intangible property when such acquisition, management, or disposition constitute integral or necessary parts of the taxpayer's trade or business operations. Gains or losses and dividend and interest income from stock and securities of any foreign or domestic corporation shall be presumed to be income from intangible property, the acquisition, management, or disposition of which constitute an integral part of the taxpayer's trade or business; such presumption

State*	Functional & Transactional	Transactional Only	Cases/Statutory Sections and Some Sample Instructions from Selected States
			may only be overcome by clear and convincing evidence to the contrary. Idaho Administrative Rules §§ 35.01.01.035.01, .02, .038 Idaho in Compact allows election of original UDITPA (Idaho Code § 63-3701) as alternative to foregoing; no Idaho judicial authority on functional test under original UDITPA. Adopted MTC Uniformity Recommendations as of 1987 on General Allocation and Apportionment and not subsequent revisions.
Illinois	**Yes**		*National Realty and Investment Company v. Illinois Dep't. of Revenue,* 494 NE2d 924 (2d Dist. IL. 1986) *Dover Corporation v. Dep't of Revenue,* 648 NE2d 1089 (1st Dist. IL. 1995) *The Kroger Company v. Department of Revenue*, 673 NE2d 710, (1st Dist. IL. 1996) Pet. Leave to App. to Illinois Supreme Court Denied , 677 N.E.2d 966 (1997) *Texaco-Cities Pipeline Company v. McGaw,* 695 NE2d 481 (IL. 1998) 35 ILCS 5/1501(a)(1) The term "business income means income arising from transactions and activity in the regular course of the taxpayer's trade or business, net of deductions allocable thereto, and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of taxpayer's regular trade or business operations. Such term does not include compensation or deductions allocable thereto. 86 Ill. Adm. Code Ch. I, §§100.3010 (a) and (d), 100.3320, 100.3340, 100.3380
Indiana	**Yes**	**N/A**	*Hunt Corp. v. Department of State Revenue, 709* N.E.2d 766 (Ind. 1999). Indiana Code ("IC") § 6-3-1- 20 (1998): "'Business Income' is defined in the Act as income from transactions and activity in the regular course of the taxpayer's trade or business, including income from tangible and intangible property if the acquisition, management, or disposition of the property are integral parts of the taxpayer's regular trade or business. Nonbusiness income means all income other than business income. The classification of income by the labels occasionally used, such as manufacturing income, compensation for services, sales income, interest, dividends, rents, royalties, gains, operating income, non-operating income, etc., is of no aid in determining whether income is business or nonbusiness income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly, the critical element in determining whether income is 'business income' or 'nonbusiness income' is the identification of the transactions and activity which are the elements of a particular trade or business. Authority: IC 6-8.1-3-3 Affected: IC 6-3-1-20 (Department of State Revenue; Indiana Administrative Code, Reg. 6-3-1-20(010); filed Oct 15, 1979, 11:15 am: 2 IR 1521; errata, 2 IR 1743) 45 IAC 3-1-1-29 through 3-1-1-31." Has informally Adopted in part MTC Uniformity Recommendations as of 1987 on General Allocation and Apportionment
Iowa	**Yes**		*Phillips Petroleum v. Iowa Dep't of Revenue & Fin.* , 511 N.W.2d 608 (Iowa, 1993) *Super Value Stores, Inc. v. Iowa Department of Revenue and Finance,* 479 N.W. 2d 255 (Iowa, 199_) *cert. denied* 505 U.S. 1213 (1999) Iowa Code Ann. § 422.32: "Business income means income arising from transactions and activity in the regular course of the taxpayer's trade or business; or income from tangible and intangible property if the acquisition management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations; or gain or loss resulting from the sale, exchange, or other disposition of real property or of tangible or intangible personal property if, if the property while owned by the taxpayer was operationally related to the taxpayer's trade or business carried on in Iowa or operationally related to sources within Iowa, or the property was operationally related to sources outside this state and to the taxpayer's trade or business carried on in Iowa; or gain or loss resulting from the sale exchange or other disposition of stock in another corporation if the activities of the other corporation were operationally related to the taxpayer's trade or business carried on in Iowa while the stock was owned by the taxpayer. A taxpayer may have more than one regular trade or business in determining whether income is business income. It is the intent of the general assembly to treat as apportionable business income all income that may be treated as apportionable business income under the Constitution of the United States. (January 1, 1995)"

State*	Functional & Transactional	Transactional Only	Cases/Statutory Sections and Some Sample Instructions from Selected States
Kansas	**Yes**		*Appeal of Chief Industries*, 875 P.2d 278 (Ka. 1994) Kansas Statute Ann. § 79-3271(a) provides an election: ". . . except that for taxable years commencing after December 31, 1995, a taxpayer may elect that all income derived from the acquisition, management, **use or** disposition of tangible or intangible property constitutes business income. The election shall be effective and irrevocable for the taxable year of the election and the following nine taxable years. The election shall be binding on all members of a unitary group of corporations." Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment.
Maine	**Yes**		Full apportionment within Constitutional Limitations since 1987. *Albany Intern. Corp. v. Halperin* (Me. 1978), 388 A.2d 902. Multistate, multinational corporate taxpayer's income arising from activity in regular course of operations of its out-of-state divisions having no relationship with business of its division in state was properly reclassified by state tax assessor from "nonbusiness income" to "business income," which produced deficiency in taxpayer's state income tax returns, even though taxpayer contended that definition of "business income" should require that transactions from which it was derived have some connection with taxpayer's regular business operations in state. 36 Maine Rev. Statutes Ann. § 5102. 8 "Maine net income. 'Maine net income' means, for any taxable year for any corporate taxpayer, the taxable income of that taxpayer for that taxable year under the laws of the United States as modified by section 5200-A and apportionable to this State under chapter 821. To the extent that it derives from a unitary business carried on by 2 or more members of an affiliated group, the Maine net income of a corporation is determined by apportioning that part of the federal taxable income of the entire group that derives from the unitary business. If a taxable corporation is an S corporation, 'Maine net income' means the amount taxable at the federal level pursuant to the Code, Sections 1374 and 1375. 8-A. Repealed. Laws 1983, c. 571, § 15. 8-B. Repealed. Laws 1981, c. 704, § 9, eff. Dec. 1,1982. 9. Repealed. Laws 1979, c. 378, § 35." 36 Maine Rev. Statutes Ann. § 5102.10. "Taxable corporation. 'Taxable corporation' means, for any taxable year, a corporation that, at any time during that taxable year, realized Maine net income. 'Taxable corporation' includes any S corporation that is required by section 5241 to file a return and that is subject to federal tax under the Code, Section 1374 and 1375.
Maryland	**N/A**	**N/A**	Full apportionment within Constitutional Limitations *NCR Corporation v. Comptroller of the Treasury, Income Tax Division*, 544 A.2d 764 (Md. Ct. App. 1988). *Hercules, Inc. v. Comptroller of Treas.*, 117 Md. App. 29, 699 A.2d 461 (1997). Maryland Code Ann. § 10-402 "(a) In general. -- In computing Maryland taxable income, a corporation shall allocate Maryland modified income derived from or reasonably attributable to its trade or business in this State in the following manner: (1) if a corporation carries on its trade or business wholly within the State, the corporation shall allocate to the State all of the Maryland modified income of the corporation; and (2) if a corporation carries on its trade or business in and out of the State, the corporation shall allocate to the State the part of the corporation's Maryland modified income that is derived from or reasonably attributable to the part of it s trade or business carried on in the State, in the manner required in subsection (b), (c), or (d) of this section."
Massachusetts	**N/A**	**N/A**	Full apportionment within state/constitutional limitations. See apportionment provisions contained in the Mass. Gen. Laws Ch. 63 § 30 "net income" 803 Mass. Regs. Code, CMR § 63.38.1 (Apportionment regulation) Mass. cases use the term "business income" because of the constitutional ramifications statute does not., *See, e.g., Gillette Company, v. Commissioner of Revenue*, 683 N.E.2d 270 (Ma. 1997)

State*	Functional & Transactional	Transactional Only	Cases/Statutory Sections and Some Sample Instructions from Selected States
Michigan	**N/A**	**N/A**	Full apportionment within Constitutional Limitations Michigan Compiled Laws Ann. § 208.3 "(3) 'Business income' means federal taxable income, except that for a person other than a corporation it means that part of federal taxable income derived from business activity. For a partnership, business income includes payments and items of income and expense which are attributable to business activity of the partnership and separately reported to the partners."
Minnesota	**N/A Statutory Change after *Firstar and Hercules***		Full apportionment within Constitutional Limitations *Firstar Corporation v. Commissioner of Revenue*, 575 N.W.2d 835, 838 (MN. 1998): Minn.Stat. § 290.17, subds. 2(f), 3, and 6, the subdivisions at issue in the present case. Id. at 1092-98. This statutory language provides that nonbusiness income is assigned to the taxpayer's domicile, and is not apportionable to Minnesota. Although Minn.Stat. § 290.17 still differentiated between business and nonbusiness income, the legislature enacted no new section defining business and nonbusiness income to replace the deleted definitional section contained in Article IV. The tax court in the instant case concluded that the repeal of Article IV also resulted in the rejection of UDITPA's definition of business income in Minnesota, stating without any further explanation that "Minnesota has a more expansive definition of apportionable business income." While the exact UDITPA language defining business and nonbusiness income is no longer part of the statute, the fact that Minn. Stat. § 290.17 still differentiates between the two types of income indicates the legislature's continuing intent to tax only that portion of a taxpayer's income generated from carrying on a trade or business. Upon comparison of the UDITPA definitions of business and nonbusiness income and the language contained in Minn. Stat. § 290.17, subd. 3, we can draw no meaningful distinction between income "arising from transactions and activity in the regular course of the taxpayer's trade or business" and income "derived from carrying on a trade or business." Accordingly, we conclude that Minnesota's current definition of business income is not any more expansive than the definition contained in UDITPA, despite the 1987 repeal of Article IV. *Hercules v. Commissioner of Revenue*, 575 N.W. 2d 111 (MN. 1998): Minn. Stat. § 290.17, subd. .3 (1999) the statute was amended dropping both tests; business income is all income except for nonbusiness income. Nonbusiness income is defined as ". . . income of the trade or business that cannot be apportioned by this state because of the United States Constitution or the constitution of the state of Minnesota and includes income that cannot be constitutionally apportioned to this state because it is derived from a capital transaction that solely serves an investment function." Minn. Stat. § 290.17, subd. 6 (1999).
Mississippi	**Yes**		*Mississippi State Tax Comm'n v. Chevron USA, Inc.*, 650 So.2d 1353 (Miss. 1995) *Ashland Pipeline v. Marx*, 623 So.2d 995 (Miss. 1993) Miss. Code Ann. § 27-7-23 "Net income of nonresidents; foreign Corporations (a) Definitions. (2) 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. (3) 'Nonbusiness income' means all income other than business income." Mississippi Income Tax R. 806(II)(A) (restates verbatim the definition from the statute and Reg. 806(II)(B) discusses instances when the tests are applied to rents, gains or losses, interest, etc.
Missouri	**Yes**		*L.A.F. Delaware Co. v. Director of Revenue* , Case No. RI-82-0451, Missouri Administrative Hearing Commission (6/3/87) 1987 Mo. Tax Lexis 286 *Williams Companies, Inc. v. Director of Revenue*, 799 S.W.2d 602,606(Mo. Banc 1990), overruled [different considerations, *General Motors Corporation and Subsidiaries, v. Director of Revenue*, 981 S.W.2d 561 (Mo. *en* banc 1998)]. Missouri Rev. Statute (1994) § 32.200, art. IV 1(1), "1. As used in this article, unless the context otherwise requires: (1) 'Business

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			income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations." Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment.
Montana	**Yes**		*Harvey Zoon & Sons Logging Co. v. Dep't of Revenue*, Montana State Tax Appeal Board CT –1994-5 (1995) *Decatur Development, Inc. v. Dep't Revenue*, Montana State Tax Appeal Board CT-1996-3 (1996) *Montana Dep't of Revenue v. Jewel Companies*, First Judicial District Court CDV-93-1562 (1994). *AT&T v. State Tax Appeal Board*, 787 N.W.2d 754 (Mont. 1990) Montana Code Ann. 15-31-302 Montana Admin. R. § 42.26.207 Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment.
Nebraska	**Yes**		Full apportionment within constitutional limitations) no distinction recognized between business and nonbusiness. Neb. Rev. Stat. 77-2734.04 Nebraska Corporate Income Tax Regulation § 24-053.
New Hampshire	**N/A**	**N/A**	Full apportionment with constitutional limitations *Caterpillar Tractor Co. v. New Hampshire Dep't of Revenue Administration*, 741 A2d 56 (NH 1999) "Business profits tax," Business enterprise tax," and franchise tax (utilities). See New Hampshire Rev. Statutes Ann. ("RSA") § 77-A:1, XIII:2-b. See RSA 77-A:1, VI (defining "gross business income") "VI. 'Gross business income' means all income for federal income tax purposes from whatever source derived in the conduct of business activity, including but not limited to gross proceeds from sales, compensation for rendering services, gross proceeds realized from trading in stocks, bonds, or other evidences of indebtedness, gross proceeds realized from sale of assets used in trade or business, interest, discount, gross rents, royalties, fees, commissions, dividends, without any deduction on account of the cost of property sold, the cost of materials used, labor costs, interest, discount, delivery costs, taxes, or any other expense paid or accrued and without any deduction on account of losses. See RSA 77- A:1, VI payments for goods, services, and rents; RSA 77-A:1, IV ("taxable business profits" includes income from foreign and domestic sources) with RSA 77-A:1, XIII ("combined net income" includes income of only domestic entities)
New Jersey	**Yes**		*Allied Signal v. Director of Revenue*, 504 U.S. 768 (1992) "Unitary Taxation in New Jersey" 28 Seton Hall L. Rev. 162 (1997) New Jersey Rev. Statutes § 54:10A-6.1: "Operational and nonoperational income. a. 'Operational income' subject to allocation to New Jersey means income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations and includes investment income serving an operational function. Income that a taxpayer demonstrates with clear and cogent evidence is not operational income is classified as nonoperational income, and the nonoperational income of taxpayers, other than those that have their principal place from which the trade or business of the taxpayer is directed or managed in this State, is not subject to allocation." See Instructions to Schedule "O" CBT-100 which actually discusses both the transactional and function tests: The **transactional** test will determine whether the acquisition, management, use, or disposition of property is in the regular course of the corporation's trade or business. A transaction or activity can occur in the regular course of business even though the taxpayer has not engaged in such transactions if it is reasonable to conclude that transactions or activities of that type that are

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			customary for the kind of business being conducted. The determination of operational income under the transactional test requires not only knowledge of how often the taxpayer's trade or business has engaged in transactions of the type at issue, but also whether such transactions are likely to occur at all in that trade or business. The **functional** test will determine whether property or activities that do not rise to the level of constituting a trade or business would still be deemed operational if that property from which income and expenses are derived is or was an integral or functional component to or part of the taxpayer's regular trade or business operations. Income and expenses derived from activities occurring infrequently, including transactions made in liquidation, are operational if that property was used in the business operations. The functional test focuses on the function played by the corporation's trade or business, and it applies similarly to tangible as well as intangible property. Income, gains, losses or expenses arising from transactions involving intangible property, for example corporate stock or an ownership interest in a partnership is operational in nature if the corporation held that intangible or the underlying property represented as an integral or functional component of its trade or business. The **operational** test will determine whether intangible property served an operational rather than an investment function. The relevant inquiry focuses on the objective characteristics of the intangible property's acquisition or use and the relation to the corporation's overall activities. This test will include as operational income all other income or gain that the State is not prohibited from taxing by the U.S. Constitution.
New Mexico	**Yes**		*McVean & Barlow, Inc. v. New Mexico Bureau of Revenue*, 543 P.2d 489, 491 (N.M. Ct. App. 1975). New Mexico Statutes Ann. 1978 §7-4-2(A). "Business income includes income from tangible and intangible property if the acquisition, management **or** disposition of the property constitute integral parts of taxpayer's regular trade or business operations." (June 18, 1999) 3 New Mexico Admin. Code § 5.1.9 (Regulation adopted change in statute, September 29, 1999). Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment.
New York	**N/A**	**N/A**	McKinney's Tax Law § 208.8 "The term 'business income' means entire net income minus investment income;. . . 6. The term "investment income" means income, including capital gains in excess of capital losses, from investment capital, to the extent included in computing entire net income, less, (a) in the discretion of the commissioner, any deductions allowable in computing entire net income which are directly or indirectly attributable to investment capital or investment income, and (b) such portion of any net operating loss deduction allowable in computing entire net income, as the investment income, before such deduction, bears to entire net income, before such deduction, provided, however, that in no case shall investment income exceed entire net income; . . ."
North Carolina	**Yes**		*Polaroid v. Offerman*, 507 S.E.2d 284, *cert. denied* 526 US 1098 (1999) *Union Carbide Corp. v. Offerman*, 526 S.E.2d 167 (N.C. 2000) *Lenox, Inc. v. Offerman*, No. COA99-1267 N.C. Gen. Stat. § 105-130.4(a)(1) N.C. Admin. Code ("NCAC") §§ T17:05C.0700, NCAC T17:05C.0702, NCAC T17:05C.0703 "The business income of the taxpayer is that portion of the taxpayer's entire net income which arises from the conduct of taxpayer's trade or business operations."
North Dakota	**Yes**		N.D.C.C. Section 57-38-1-01(1) N.D. Admin. Code Sec. 81-03-09-03 Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment.
Ohio	**Yes**		*Kempel v. Tracy* (unreported administrative decision, January 21, 2000) B.T.A. 98-698 on appeal to Ohio's Supreme Court (case summarized by Forster, Ann "Ohio BTA Adopts Business Income Tests," *State & Local Taxes Weekly* (RIA) 2/14/200

State*	Functional & Transactional	Transactional Only	Cases/Statutory Sections and Some Sample Instructions from Selected States
			Ohio Rev. Code Ann. § 5747.01(B) "'Business income' means income arising from transactions, activities, and sources in the regular course of a trade or business and includes income from tangible and intangible property if the acquisition, **rental**, management, and disposition of the property constitute integral parts of the regular course of a trade or business operation." Ohio Rev.Code Ann. § 5747.01 (C)" 'Nonbusiness income' means all income other than business income and may include, but is not limited to, compensation, rents and royalties from real or tangible personal property, capital gains, interest, dividends and distributions, patent or copyright royalties or lottery winnings, prizes and awards. "
Oklahoma	**Yes**		Full apportionment within constitutional limitations 68 Oklahoma Statutes §§ 2358 and 2362. Oklahoma Admin. Code Subchapter 17. Oklahoma Taxable Income for Corporations Part 1. General Provisions §§ 710:50-17-1 *et. seq*.
Oregon	**Yes**		*Simpson Timber Co. v. Dept. of Rev.*, 326 Or 370, 953 P2d 366 (1998) *Pennzoil Co. v. Dept. of Rev*., 2000 WL 1025573 (Tax Court March 17, 2000) *Dept. of Rev. v. Terrace Tower U.S.A. Inc.*, 2000 WL 819401 Or. Tax Regular Div., 2000. (June 15, 2000) *The Sherwin-Williams Company v. Department of Revenue*, 996 P.2d 500 (Ore. 2000). *Willamette Industries, Inc. v. Dept. of Rev*., 12 OTR 291 (1992) Oregon Rev. Stat. ("ORS") §§ 314.610(1) "Definitions for ORS 314.605 to 314.675. "As used in ORS 314.605 to 314.675, unless the context otherwise requires: (1) "Business income" means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, the management, use or rental, and the disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. . . (5) "Nonbusiness income" means all income other than business income. (1965 c. 152 § 2; 1997 c. 631 § 452)" MTC model rules, regulations and statutes on allocation and apportionment have been adopted through legislation (See, ORS Chapter 314) or administratively through rules process. Oregon law sometimes departs from the MTC model regulations, for example ORS 314,670 (additional methods to determine extent of business activity) and ORS 314.665 (sales factor) reflecting Oregon's unique treatment of certain allocation and apportionment issues.
Pennsylvania	**Yes**		*Laurel Pipe Line Co. v. Commonwealth of Pennsylvania, Board of Finance & Revenue*, 642 A.2d 472 (Pa. 1994) *Ross- Araco v. Commonwealth of Pennsylvania, Board of Finance & Revenue,* 674 A.2d 691 (1996) Pa. Stat. Ann. Art. 72 § 7401 (§ 401 Definitions) "2 (a) (1) (A) As used in this definition, unless the context otherwise requires: (A) 'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. (D) 'Nonbusiness income' means all income other than business income. "
Rhode Island	**N/A**	**N/A**	Full Apportionment within Constitutional Limitations Rhode Island Gen. Laws (1956) § 44-11-11 "Net income defined. (a)(1) 'Net income' means for any taxable year and for any corporate taxpayer, the taxable income of the taxpayer for that taxable year under the laws of the United States, plus (i) any interest not included in the taxable income, (ii) any specific exemptions, and (iii) the tax imposed by this chapter, and minus (iv) interest on obligations of the United States or its possessions, and other interest exempt from taxation by this state, and (v) the federal net operating loss deduction."
South Carolina	**N/A**	**N/A**	Full apportionment within constitutional limitations S. C. Code Ann. § 12-7-700 "Appellant urges application of the broad definition of contained in the Uniform Division of Income for Tax Purposes Act. While

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			the General Assembly elected to incorporate some of the language from the Uniform Act into Code s 12-7-1120(6), it did not adopt the Act's definition of business income." *Boyle Utilities, Inc., v. The South Caroline Tax Commission*, 254 S.E.2d 308 (SC 1979)
Tennessee	**Yes**		*Associated Partnership I, Inc. v. Huddleston* 889 S.W.2d 190, (SC 1994); *Federated Stores Realty v. Huddleston*, 852 S.W. 2d 206 (SC 1992). Tenn. Code. Ann. § 67-4-2004 (July 1, 1999): (1) "Business earnings" mean earnings arising from transactions and activity in the regular course of the taxpayer's trade or business or earnings from tangible and intangible property if the acquisition, use, management or disposition of the property constitutes an integral part of the taxpayer's regular trade or business operations. In essence, earnings which arise from the conduct of the trade or trades or business operations of a taxpayer are "business earnings," and the taxpayer must show by clear and cogent evidence that particular earnings are classifiable as nonbusiness earnings. A taxpayer may have more than one (1) regular trade or business in determining whether income is "business earnings." This subdivision expresses the legislative intent to implement and clarify the distinctions between business and nonbusiness earnings, as found in the Uniform Division of Income for Tax Purposes Act, as generally interpreted by states adopting the act ;. . .
Utah	**Yes**		*Steiner Corporation v. Auditing Division of the Utah State Tax Commission*, 979 P.2d 357 (UT. 1999). Utah Statutes Ann. § 59-7-302(1) "'Business income' means income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business operations.' Adopted MTC Uniformity Recommendations as of 1997 on General Allocation and Apportionment.
Vermont	**N/A**	**N/A**	Full apportionment within Constitutional Limitations 32 Vermont Statutes Ann. § 5811: (18) "'Vermont net income' means, for any taxable year and for any corporate taxpayer, the taxable income of the taxpayer for that taxable year under the laws of the United States, excluding income which under the laws of the United States" *Mobil* v. *Commissioner of Revenue,* 445 U.S. 425, 100 S.Ct. 1223, 63 L.Ed.2d 510 (1980) *F. W. Woolworth Co. v. Taxation and Revenue Dept. of State of N. M.*, 458 U.S. 354, 102 S.Ct. 3128, 73 L.Ed.2d 819 (1982), *reh. den.* 459 U.S. 961, 103 S.Ct. 274, 74 L.Ed.2d 213 (1982)
Virginia	**N/A**	**N/A**	Full apportionment within constitutional limitations No distinction between business income and nonbusiness income. Dividends to be allocated to the commercial domicile of the corporation, and all other income to be apportioned. [Va. Code Ann. § 58.1-407; Va. Code Ann. § 58.1-408; Va. Admin. Code 23 §10-120-140(A).]
West Virginia	**N/A**	**N/A**	No reported cases. See W.Va. Code sections 11-23-3(b)(1) and 11-24-3a(1) for definition of business income. The same definition is used in the regulations Code of State Rules § 110-24-3a.1; Code of State Rules § 110-24-7.4.1; West Virginia Taxpayer Services Division Publications TSD-392.
Wisconsin	**Yes***		*Based upon this author's analysis of Wisconsin's statute it is her conclusion that income satisfying either test would be considered business income. The Wisconsin courts never adopted either the "transactional or functional" test. The courts just use the terms business and nonbusiness income or "apportionable" and "nonapportionable income." *Port Affiliates, Inc. v. Wisconsin Department of Revenue* 190 Wis 2d 272, 526 NW2d 806, 12/20/1994, Pet. For Leave to Appeal, denied 2/21/95. *Wisconsin Department of Revenue v. Citizen Publishing Co. of Wisconsin, Inc.* 520 N.W.2d 110 (Wi. 2000 unpub. Op.) *Midland Financial Corporation v. Wisconsin Dep't of Revenue*, 341 N.W.2d 397 (Wi. 1983) "It points out that net business income

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			in section 71.06, is defined as 'all the income attributable to the operation of a trade or business regularly carried on by the taxpayer, less the deduction of business expenses allowed in section 71.04.'" (341 N.W.2d at 400) Wisconsin Statutes Ann. §§ 71.25(5),(6),(10),(12) and 71.26(4) as well as current Wis. Admin. Code Tax §2.39. Wisconsin Statutes Ann. provides: (5) Corporations engaged in business both within and without the state. (a) Apportionable income. Except as provided in sub. (6), corporations engaged in business both within and without this state are subject to apportionment. Income gain or loss from the sources listed in this paragraph is presumed apportionable as unitary or operational income or other income that has a taxable presence in this state. Apportionable income includes all income or loss of corporations, other than nonapportionable income as specified in par. (b), including, but not limited to, income, gain or loss from the following sources: 1. Sale of inventory. 2. Farms, mines and quarries. 3. Sale of scrap and by-products. 4. Commissions. 5. Sale of real property or tangible personal property used in the production of business income. 6. Royalties from intangible assets. 7. Redemption of securities. 8. Interest on trade accounts and trade notes receivable. 9. Interest and dividends if the operations of the payer are unitary with those of the payee, or if those operations are not unitary but the investment activity from which that income is derived is an integral part of a unitary business and the payer and payee are neither affiliates nor related as parent company and subsidiary. In this subdivision, "investment activity" includes decision making relating to the purchase and sale of stocks and other securities, investing surplus funds and the management and record keeping associated with corporate investments, not including activities of a broker or other agent in maintaining an investment portfolio. 10. Sale of intangible assets if the operations of the company in which the investment was made were unitary with those of the investing company, or if those operations were not unitary but the investment activity from which that gain or loss was derived is an integral part of a unitary business and the companies were neither affiliates nor related as parent company and subsidiary. In this subdivision, "investment activity" has the meaning given under subd. 9. 11. Management fees. 12. Franchise fees. 13. Treble damages. 14. A partner's share of income or loss from a partnership or a member's share of income or loss from a limited liability company. 16. Foreign exchange gain or loss. 17. Sale of receivables. 18. Rentals of, or royalties from, real property or tangible personal property if that real property or tangible personal property is used in the business. 19. Sale or exchange of petroleum at the wellhead. 20. Personal services performed by employees of the corporation. 21. Patents, copyrights, trademarks, trade names, plans, specifications, blueprints, processes, techniques, formulas, designs, layouts, patterns, drawings, manuals and technical know-how. 22. Redemption of the corporation's bonds. 23. Interest on state and federal tax refunds on business income or business property. 24. Pari-mutuel wager winnings or purses under ch. 562. (b) Nonapportionable income. 1. Income, gain or loss from the sale of nonbusiness real property or nonbusiness tangible personal property, rental of nonbusiness real property or nonbusiness tangible personal property and royalties from nonbusiness real property or nonbusiness tangible personal property are nonapportionable and shall be allocated to the situs of the property, except that all income that is realized from the sale of or purchase of and subsequent sale or redemption of lottery prizes if the winning tickets were originally bought in this state shall be allocated to this state. 2. All income, gain or loss from intangible property that is earned by a personal holding company, as defined in section 542

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			of the internal revenue code, as amended to December 31, 1974, shall be allocated to the residence of the taxpayer, except that all income that is realized from the sale of or purchase and subsequent sale or redemption of lottery prizes if the winning tickets were originally bought in this state shall be allocated to this state.
Multi-State Tax Commission	**Yes**		UDITPA §1(a) Comments MTC. REG. IV.1. (a). **Business and Nonbusiness Income Defined.** Article IV.1.(a) defines "business income" as income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitute integral parts of the taxpayer's regular trade or business operations. In essence, all income which arises from the conduct of trade or business operations of a taxpayer is business income. For purposes of administration of Article IV, the income of the taxpayer is business income unless clearly classifiable as nonbusiness income. Nonbusiness income means all income other than business income. The classification of income by labels occasionally used, . . . is of no aid in determining whether income is business or non-business income. Income of any type or class and from any source is business income if it arises from transactions and activity occurring in the regular course of a trade or business. Accordingly the critical element in determining whether income is "business income" or "nonbusiness" income is the identification of the transactions and activity which are the elements of a particular trade or business. In general all transactions and activities of the taxpayer which are dependent on upon or contribute to the operations of the taxpayer's economic enterprise as a whole constitute that taxpayer's trade or business and will be transactions and activity arising in the regular course of, and will constitute integral parts of a trade or business.